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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

LEA MÁRQUEZ PETERSON, Chairwoman
SANDRA D. KENNEDY
JUSTIN OLSON
ANNA TOVAR
JIM O'CONNOR

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	DOCKET NO. E-01345A-19-0236 **ARIZONA PUBLIC SERVICE COMPANY'S APPLICATION FOR REHEARING/RECONSIDERATION**

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TABLE OF CONTENTS

I. <u>INTRODUCTION AND SUMMARY</u>

Clean, affordable, and reliable electricity provided by Arizona Public Service Company ("APS" or "Company") and its peer electric utilities has provided a strong foundation for the economic growth Arizona residents currently enjoy. As APS and its peers embark on a transition towards an electricity generation portfolio marked by greater reliance upon advanced, clean-energy technologies, regulatory stability and consistency are evermore critical to ensuring that this transition is accomplished safely, reliably, and affordably for customers. However, unless overturned, Decision No. 78317[1] will stifle system and economic growth, produce higher customer costs in the future, and threaten the reliability of Arizona's electric power supply system during and after the transition to cleaner sources of power generation. The relief detailed herein must be granted because the Decision is arbitrary, impermissibly punitive,[2] untethered to the record, and contrary to law, precedent, and practice.

Indeed, in pursuit of a pre-determined, punitive agenda,[3] the Commission disregarded in many instances the advice of its own Staff and its Administrative Law

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[1] Decision No. 78317 (Nov. 9, 2021) Ariz. Corp. Comm'n Docket No. E-01345A-19-0236 (*In the Matter of the Application of Arizona Public Service Company*) (hereinafter "Decision No. 78317" or "the Decision").

[2] *See, e.g.*, Fitch Downgrades Pinnacle West Capital & Arizona Public Service to 'BBB+'; Outlooks Remain Negative, Fitch Ratings (Oct. 12, 2021) (characterizing the order's 8.7% ROE as "punitive").

[3] *See* Docket No. E-01345A-19-0003, *In re: Rate Review and Examination of the Books and Records of Arizona Public Service Company*, Open Mtg. Tr. at 59:2-16 (June 11, 2019) (Commissioner Kennedy imploring fellow Commissioners to adopt an amendment retroactively reducing APS customer rates downward and stating that "[b]ecause it takes 12 months to do a rate case for a Class A company, again, we are talking about months down the road of giving some relief to the ratepayers. . . . I believe that some relief is due to the ratepayers. The question is how do we go about doing it and when do we do it. And there is no other time than now to tackle that issue"); *In re: Rate Review and Examination of the Books and Records of Arizona Public Service Company,* Decision No. 77270 at 11 (June 27, 2019) (ordering APS to file a rate case no later than October 31, 2019 in the absence of taking immediate action to retroactively reduce APS rates as considered during the June 11, 2019 Commission Open Meeting); Spec. Open Mtg. Tr. Vol. III at 633:1-3 (Oct. 6, 2021) (Chwm. Márquez Peterson referring to the 20 basis point reduction in Cost of Equity as a "penalty, in essence"); Letter from Commissioner Justin Olson to Docket No. E-01345A-19-0236 (Aug. 3, 2021) (stating his intent to file an amendment to the Recommended Opinion and Order ("ROO"), issued the prior day, to adopt the 20 basis-point return on equity penalty recorded by RUCO, which was not adopted by the Administrative Law Judge's ROO).

Judges.[4] In other instances, the Commission went so far as to fashion out of whole cloth new grounds for denying reimbursement to APS to penalize it in ways that no party had even suggested and for which the record provides no support. The Commission also invented and applied *ex post facto* a new approach to the prudence inquiry that is contrary to the Commission's own rules and longstanding practice, contradicts the Commission's own prior treatment of APS's investment in the Four Corners Power Plant ("Four Corners" or "Plant"), ignores the fundamental threat to the reliability of Arizona's electric power supply system that is posed by this new approach, and unlawfully and arbitrarily deprives APS of its reasonable investment-backed expectations.

The result of this process so far has been a decision that gives APS only a fraction of the revenue requirement to which the Company is legally entitled and that it needs to continue to operate and improve its system in a reliable and efficient manner for the long-term benefit of customers and the State. While customers will see lower base rates in the near-term, the Decision will ultimately harm them by limiting APS's ability to improve and transition its system and by driving up its costs for accessing capital, both debt and equity. This Decision cannot be permitted to stand.

APS thus requests rehearing and reconsideration under Ariz. Rev. Stat. § 40-253 with respect to the following findings, conclusions, and directives in Decision No. 78317:

- The disallowance from rate recovery of $215.5 million of APS's capital investment in selective catalytic reduction reactors ("SCRs") for Units 4 and 5 of Four Corners;
- The establishment of a return on equity ("ROE") of 8.7%, inclusive of a 20 basis point ("b.p.") reduction for alleged customer service issues;

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[4] The Commission disregarded the recommendations of the Administrative Law Judge who heard this evidence in this matter. In addition, the Commission disregarded the recommendations of the Administrative Law Judge, who in 2018 conducted a fulsome evidentiary hearing on the prudency of the selective catalytic reduction pollution control equipment ("SCRs") for Four Corners. The ALJ in that proceeding issued a recommended opinion and order finding the SCRs prudent. For purposes of this Application, APS will identify the relevant Administrative Law Judge by including the parenthetical year (2018) or (2019) thereafter.

- A return on the fair value increment ("FVI") of APS's rate base of 0.15%;
- The disallowance from rate recovery of 15% of the value of APS's regulatory asset associated with the retired Navajo Generating Station ("NGS"); and
- A reduction to APS's rate base of $76.45 million resulting from an adjustment to the actual value of its prepaid pension asset.

Although the Commission has a range of discretion in the exercise of its ratemaking authority, the Arizona Constitution and the Arizona Revised Statutes impose meaningful constraints and limitations on the exercise of that discretion. Accordingly, the Commission's findings and conclusions in ratemaking proceedings will not be sustained if they are "arbitrary, unlawful, or unsupported by substantial evidence." *Sun City Home Owners Ass'n v. Ariz. Corp. Comm'n*, 496 P.3d 421, 425 (Ariz. 2021) (citing *Johnson Utils., LLC v. Ariz. Corp. Comm'n*, 249 Ariz. 215, 222 (2020)). *See also Freeport Minerals Corp. v. Ariz. Corp. Comm'n*, 244 Ariz. 409, 411 (App. 2018) (quoting *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434 (App. 1994)) (same). "Mere speculation and arbitrary conclusions are not substantial evidence and cannot be determinative." *City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 481 (App. 1972). In addition, the Commission cannot "depart from a prior policy *sub silentio*" and, if it does depart from prior policy, it "must show that there are good reasons for the new policy." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009). The Commission's findings, conclusions, and directives in Decision No. 78317 run afoul of these requirements. Accordingly, the Decision must be revised.

In addition, the Commission must be mindful of the fact that the Arizona courts will review the Commission's decision here *de novo*. Indeed, under recently amended law, Arizona courts reviewing final Commission decisions "shall decide all questions of law [and] . . . *all questions of fact without deference* to any previous determination that may have been made on the question by the agency." Ariz. Rev. Stat. § 12-910(F) (as amended by 2021 Ariz. Legis. Serv. Ch. 281 (S.B. 1063)) (emphasis added).

In Decision No. 78317, the Commission violated these fundamental legal standards in multiple ways, including:

- The Decision is contrary to Arizona and federal law, violates Commission regulations and precedent, and makes findings without substantial evidence to arbitrarily and capriciously disallow from rate recovery a substantial portion ($215.5 million) of APS's capital investment in federally required emissions control technology for Four Corners Units 4 and 5.
- The Decision violates the Arizona Constitution, Arizona law, and basic principles of due process insofar as it reduces APS's ROE by 20 b.p. as a sanction for alleged customer service issues, resulting in a penalty that was imposed without prior notice and that far exceeds the maximum $5,000 penalty permitted by law.
- The Decision denies APS a lawful and appropriate ROE insofar as the 8.7% ROE is insufficient to attract capital and maintain confidence in APS's financial integrity and is not commensurate with returns on comparable investments, as required by long standing principles established in *Federal Power Commission v. Hope Natural Gas Company* ("*Hope*") and *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia* ("*Bluefield*"), cited *infra*.
- The Decision establishes a return on the FVI of APS's investment base that is tantamount to zero, and therefore violates the Arizona Constitution's requirement that APS must be compensated based on the fair value of its investments and not merely the book value.
- The Decision denies APS recovery of 15% of the value of APS's regulatory asset associated with the retired NGS in violation of the fundamental ratemaking principle that a utility must be allowed an opportunity to earn a reasonable return on its prudent investments.

- The Decision arbitrarily disallows the inclusion in rate base of the full value of APS's prepaid pension asset through what the Commission characterizes as "normalization," notwithstanding the fact that the asset is steadily growing.

In all, as detailed herein, Decision No. 78317 is "arbitrary, unlawful, or unsupported by substantial evidence," and must be revised as detailed herein. *Sun City Home Owners Ass'n*, cited *supra.*[5]

II. DECISION NO. 78317 ARBITRARILY, UNLAWFULLY, AND WITHOUT SUBSTANTIAL EVIDENCE DENIES APS FULL COST RECOVERY FOR THE FOUR CORNERS SCRS.

In Decision No. 78317, the Commission unlawfully disallowed from rate recovery $215.5 million (approximately 52%) of APS's capital investment in SCRs (together with the capital investment made ("SCRs Investment")) to control emissions from Four Corners Units 4 and 5, based on a finding of purported "planning imprudence." Decision No. 78317 at 116-24. This refusal to allow recovery of a significant portion of the value of APS's used and useful public utility property is unprecedented. The Commission claims that its decision to disallow recovery of such an investment is based on APS's recent decision to retire Four Corners in 2031 rather than 2038. Yet, the Commission finds that this very same decision to retire Four Corners early "will benefit APS's ratepayers, the public, and the environment[.]" *Id.* at 116-19. In other words, the Commission justifies partial recovery of the SCRs Investment based on APS's beneficial decision to retire Four Corners early, but also deems the same decision grounds to disallow a substantial portion of the SCRs Investment. This arbitrary and internally inconsistent rationale is the antithesis of reasoned decision making and cannot withstand review.

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[5] To the extent APS does not expressly repeat an issue, argument, or exception it previously made in this docket, APS incorporates herein the additional issues, arguments, and exceptions set forth in Arizona Public Service Company's Exceptions to the Recommended Opinion and Order, Docket No. E-01345A-19-0236 (*filed* Sept. 13, 2021), Arizona Public Service Company's Reply Brief, Docket No. E-01345A-19-0236 (*filed* Apr. 30, 2021), and Arizona Public Service Company's Initial Post-Hearing Brief, Docket No. E-01345A-19-0236 (*filed* Apr. 6, 2021).

The Commission's disallowance decision also asserts that APS "intentionally manipulated" its load forecasts in 2016 and in the current rate case in a purportedly intentional effort to deceive the Commission. The record is completely devoid of evidence to support this false allegation. The Commission's injection of this issue at the close of the process (which no party raised during the proceedings) constitutes a blatant violation of APS's due process rights because the Commission never provided APS with an opportunity to address it in a timely and appropriate manner during the evidentiary proceedings. Moreover, to the extent the Commission's disallowance of a substantial portion of the SCRs Investment rests on this purported finding and/or on the purported finding of "planning imprudence," it constitutes the impermissible imposition of a penalty far in excess of the Commission's constitutional and statutory authority. Such imposition of a penalty also contravenes the Commission's obligation to provide advance notice and an opportunity to be heard before imposition of any forfeiture or penalty for violations of Commission rules and standards.

Decision No. 78317's disallowance of a substantial portion of the SCRs Investment based on a purported finding of planning imprudence also violates the unambiguous terms of the Commission's prudence rules because it is irreconcilable with the rule's presumption of prudence. The Commission fails to identify the requisite clear and convincing evidence of imprudence based on facts reasonably known to APS at the time it made its investment decision, thereby upending the regulatory allocation of the burden of proof for parties challenging the presumption of prudence. This approach impermissibly shifts to the utility a previously unarticulated legal burden to overcome a presumption of imprudence. In addition, the Commission's planning imprudence rationale impermissibly relies on extensive hindsight evidence that was not and could not have been available to APS at the time it made its investment decision, in violation of the Commission's own prudence rule.

Additionally, Decision No. 78317's disallowance of a substantial portion of the SCRs Investment is arbitrary and contrary to law and unsupported by the record because it retroactively departs from longstanding agency practice without notice. In this respect, the Commission—on a totally ad hoc basis—announced a "new rule" in Decision No. 78317 that public utilities must conduct a distinct assessment of prudence for each new payment a public utility makes toward an ongoing project. The retroactive application of this new rule unconstitutionally upsets APS's reasonable, investment-backed expectations arising from the Commission's prior practice. It also upends without explanation prior Commission findings that authorized APS to proceed with the acquisition of Southern California Edison's ("SCE") ownership interests in Four Corners Units 4 and 5 ("SCE Transaction"). Prior Commission decisions explicitly approved the SCE Transaction, which included retirement of Four Corners Units 1, 2 and 3 and the plans to install SCRs on Units 4 and 5, as a prudent venture. These are determinations that the Commission has never departed from nor reversed, but now seeks to ignore by denying APS a just and reasonable recovery through the illegal ad hoc application of a different standard to a single utility, which would otherwise constitute unlawful rulemaking. The retroactive application of this new rule is arbitrary and capricious because the Commission has not even acknowledged its creation of a new rule and departure from prior practice, let alone attempted to justify its novel approach and application here.

For all these reasons, Decision No. 78317's disallowance of full recovery of and on the SCRs Investment is arbitrary and capricious, contrary to law, and unsupported by substantial evidence. Indeed, the Commission should revise Decision No. 78317 to authorize APS cost recovery of the full value of the SCRs Investment at the Company's weighted average cost of capital. Such a determination would be consistent with Commission precedent and rules, and is supported by substantial evidence.

A. The SCRs Are Integral to the Generation of Electric Power at Four Corners, Which Is Necessary to Ensuring the Reliability of Arizona's Electric System As It Transitions to Cleaner Resources.

While APS has committed to fully decarbonizing its fleet of electric generating facilities over the long-term, the evidence, both in this and prior matters regarding Four Corners, demonstrates that continued operation of this fully dispatchable and reliable resource is necessary to ensure the near-term continued operation of the electric system in Arizona and surrounding areas so that customers may enjoy uninterrupted electric service. As such, Four Corners represents a critical bridge resource during APS's clean-energy transition. In this case, APS witness Brad Albert ("Albert") provided extensive and uncontradicted evidence establishing that Four Corners Units 4 and 5 are critical for system reliability today and for the foreseeable future. *See* Ex. APS-8 (Albert Rebuttal) at 11 (explaining how Units 4 and 5 provided significant reliability benefits to the system and to customers, particularly in the wake of the August 14 and 15, 2020 heat storm). To ensure APS has sufficient operating reserves, the Company maintains a planning reserve margin of approximately 15% for generation capacity to guarantee that it always has sufficient generation available to meet load even in emergency conditions. With these core obligations in mind, when APS set out to consider whether to continue operating Four Corners (between approximately 2010 and when SCR construction was initiated in 2015), APS, the Commission, and even intervening parties to this proceeding (e.g., the Sierra Club) presented evidence regarding numerous alternative options, including new natural gas generation and additional renewable resources. In each evaluation conducted over numerous intervals during this period, APS (as validated every time by Commission Staff) found that maintaining operations at Four Corners by closing Units 1-3, acquiring SCE's interests in Units 4 and 5, and adding SCR pollution controls to Units 4 and 5 represented the most cost-effective means to ensure APS could provide reliable service to its customers. The Commission was fully aware of the full scope of these evaluations—including the cost analyses that included the projected expense of adding the SCRs to Units 4 and 5—and nonetheless deemed this path forward a prudent strategy for ensuring cost-effective service to APS customers. *See* Decision No. 74876 at 12 (Dec. 23, 2014) Ariz. Corp. Comm'n Docket No. E-01345A-11-0224 (*In the Matter of the Application of Arizona Public Service Company*) (hereinafter "Decision No. 74876"). Significantly, no party to this proceeding submitted any evidence whatsoever that an alternative resource acquisition was available to APS between 2010 and 2015 that would have provided the same reliability value to APS customers at an equivalent or lesser cost. *See, e.g.*, Tr. Vol. XIV, Cross Examination of Tyler Comings, Sierra Club at 3083 (Feb. 10, 2021) (responding to questions about whether evidence was submitted regarding alternatives to the SCE Transaction and the SCRs Investment when the Commission deemed that transaction prudent in 2014, acknowledging "[w]ell, I did not do a forward-looking analysis of the value of the units at each of these points in time").

In accordance with Ariz. Admin. Code R14-2-704, the Commission is required to assess the reliability of APS's power supplies in its resource plans. In disallowing $215.5 million of the SCRs Investment for purported planning imprudence, the Commission (1) failed to adequately address the issue of reliability, (2) made no findings that the electric system in Arizona would in fact have remained reliable if APS had not completed the SCRs Investment and instead been forced to shut down Four Corners in 2018, and (3) ignored Mr. Albert's unrebutted testimony regarding the essential role played by Four Corners in ensuring system reliability. *See* Ex. APS-8 (Albert Rebuttal) at 16 ("I have concerns about the viability of retiring Four Corners in 2026. Four Corners represents a sizable contributor to APS system reliability. . . ."). Nor did the Commission address or acknowledge the absence of any reliability analysis in the Sierra Club's and Citizens Groups' alternative portfolios, which failed to include or address critical issues necessary for system reliability, such as reserve margins, new transmission, or firm resource needs, among other shortcomings. *See* Ex. APS-8 (Albert Rebuttal) at 3 ("Their analyses ignore the realities of operating a reliable power system and use unrealistic or improper assumptions that lead to inaccurate conclusions."). In addition, these alternative resource portfolios only reflect potential options for serving APS customers today, and have no bearing on potential alternatives to the continued operation of Four Corners (and its necessarily corresponding SCRs Investment) under consideration between 2010 and 2015. As such, hindsight consideration of these supposed alternative portfolios represents pure second-guessing of a resource acquisition strategy the Commission already approved and deemed prudent multiple times over. *See infra* Section II.B.

At hearing, Mr. Albert submitted unrefuted testimony explaining that Four Corners is "an invaluable resource when it comes to reliability, as strongly evidenced during the heat storm this last summer. The units operated at virtually full capacity during those days, and APS, unlike some other utilities in the West, was able to keep the lights on for our customers." Test. of Brad J. Albert, Tr. Vol. V at 1051 (Jan. 21, 2021). *See also* Ex. APS-8 (Albert Rebuttal) at 11 ("Four Corners Units 4 and 5 performed very well this summer and were operating at essentially full power over the late afternoon and evening hours…providing significant reliability benefits to the system and to customers."). When asked if wholesale market purchases could replace the generation capacity of Four Corners, Mr. Albert refuted the analyses of Sierra Club's and Citizen Groups' witnesses who had suggested it could be possible. Mr. Albert testified that "relying on non-asset backed market purchases to meet fundamental reliability requirements in tight market conditions like the western grid is experiencing today and is likely to experience in the future" is unacceptable from a reliability standpoint, because "[m]arket purchases like the ones used in the intervenors' cost comparisons run the risk of being cut when the non-asset backed power is not available. This was one of the issues that played a role in the rolling blackouts this summer in California." Ex. APS-8 (Albert Rebuttal) at 4-5. The record thus establishes without dispute that shutting down Four Corners and instead relying upon a combination of wide-scale adoption of battery storage technologies ("[a]dding the substantial amount of additional battery storage that would be needed to replace Four Corners on top of what is already planned would cause too much reliance on a relatively immature technology that has not been operated on a broad scale," *see* Ex. APS-9 (Albert Rejoinder) at 8), insufficient quantities of non-dispatchable variable resources ("[i]t is well-accepted that the capacity value of solar generation decreases as penetration of the resource increases on a given system," *see* Ex. APS-8 (Albert Rebuttal) at 7), and non-asset backed market purchases to address supply shortfalls during emergency periods—as advocated by the Sierra Club and Citizen Groups—would simply not have satisfied APS's reliability obligations. Taking this approach would have caused

Arizona to suffer blackouts similar to those that California experienced during high-demand periods in 2020 and will likely face again. *See* Ex. APS-9 (Albert Rejoinder) at 10 ("The reliability impacts of early closure and the ability to obtain appropriate replacement power are, however, of grave concern to APS and its customers.").

The Commission's analysis of the prudence of the SCRs Investment failed to take into account the need for Four Corners to fulfill APS's and the Arizona electric system's reliability needs before, during, and after the Test Year. Mr. Albert's testimony on the need for Four Corners Units 4 and 5 to satisfy APS's reliability obligations went unrefuted by any witness. At hearing, Staff asked Sierra Club witness Tyler Comings whether he believed reliability should be a paramount consideration when looking at the need for Four Corners; Comings responded by stating: "[a]gain, reliability is always of paramount importance." Tr. Vol. XIV at 3089. Neither Comings nor any other witness for intervenors provided a reliability assessment establishing that the resource portfolio alternatives put forth by the Sierra Club would have fulfilled APS's reliability needs and would, for example, have avoided the need for rolling blackouts during periods of high demand and tight supply in 2020 when California suffered widespread power failure. *See* Ex. APS-8 (Albert Rebuttal) at 3–4 ("Their analyses do not adequately address system reliability. APS is responsible for operating an intentionally diverse portfolio of resources and interacting with the market on a minute-by-minute basis to reliably meet customers' demand. It takes careful planning and a deep understanding of the system and resource capabilities to maintain high reliability. However, the intervenors' studies simply assume reliability with no evidence to support it."). In addition to their failure to put forth cost-effective alternatives available to APS at the relevant time when APS made its investment decisions (i.e., as to the SCE Transaction, including the SCRs Investment), the reliability of proffered alternatives to Four Corners in times of system stress was simply not addressed by any intervenor in this case. APS, on the other hand, provided evidence showing that an unplanned retirement of "Four Corners Units 4 and 5 would [ ] remove[] over 1,500 MW from the western market, causing a resource-constrained market to be even more resource-constrained and potentially leading to rolling blackouts in Arizona." Ex. APS-8 (Albert Rebuttal) at 11.

Thus, the record establishes that Four Corners is necessary to satisfy critical reliability needs. It is also undisputed that starting in 2018, Four Corners could no longer and still cannot legally operate without the SCRs. In 2012, the SCRs were identified by the Environmental Protection Agency ("EPA") as the Best Available Retrofit Technology ("BART") for Four Corners to comply with the EPA's mandatory Regional Haze regulations promulgated pursuant to the Clean Air Act. The SCRs are no less essential to the operation of Four Corners than are the boilers, turbines, and power lines that generate and transmit electricity from Units 4 and 5 throughout Arizona. In short, Arizona's electric system relies on the Four Corners resource just as power generation at the facility relies on operation of the SCRs.

Four Corners remains a critical bridge to the State's clean energy future, yet the Commission's decision arbitrarily, unreasonably and without substantial evidence denies APS the ability to recover its expenditures on this federally required and essential component of its overall resource portfolio. The Commission should reconsider its decision to disallow full recovery of the SCRs Investment before that decision chills the ability and willingness of APS and other companies to attract capital and invest in Arizona's clean energy future. By sending the message that the Commission will no longer permit public utilities in Arizona to recover their reasonable investments in facilities that are essential to the reliability of Arizona's electric power system, the Commission is creating a regulatory environment that could put Arizona electricity customers at risk of suffering the same fate as that faced by California electricity customers in 2020.

B. The Commission's Prior Decisions Establish the Prudence of APS's Decision to Invest in the SCRs, and APS Therefore Acted Reasonably in Investing Hundreds of Millions of Dollars in Reliance on Those Prior Decisions.

On November 22, 2010, APS filed with the Commission an application seeking relief from a moratorium on new facility construction (known as the self-build moratorium), and authorization of the SCE Transaction. In its application, APS identified environmental challenges facing Four Corners that threatened the Plant's future viability. APS presented evidence to the Commission establishing definitively that the EPA had determined that SCRs were the emissions controls for the reduction of nitrogen oxide emissions at Four Corners that constituted the required BART. As part of its requested authorization of the SCE Transaction in response to the EPA environmental control requirements, APS explained to the Commission that it would accelerate retirement of Four Corners Units 1-3 (eliminating 560 MW of less efficient generation) and add the SCRs to Units 4 and 5 by 2018. Assuming APS were to instead continue operating all five units at Four Corners (and thus install BART on all five units), the Company projected its share of capital costs for environmental controls could exceed $660 million. *See* Decision No. 73130 at 3 (Apr. 24, 2012), Ariz. Corp. Comm'n Docket No. E-01345A-10-0474 (*In the Matter of the Application of Arizona Public Service Company*) (hereinafter "Decision No. 73130"). As verified by Commission Staff, APS's comparison of alternatives revealed that, on a net-present value basis, the Company's proposed path forward with Four Corners—explicitly including the SCR Investment—would save customers $488 million as compared to a natural-gas power plant alternative and save customers $1.08 billion as compared to an alternative that kept Four Corners Units 1-3 in operation with environmental upgrades. *See id.* at 23.

The Sierra Club fully participated in this early proceeding and argued that APS "failed to fully analyze the financial risks of investments in coal-fired generation that will result from increasingly stringent environmental regulations and other coal related costs…and to adequately consider a range of alternatives to meet its demand needs." Decision No. 73130 at 14 (citing Sierra Club Post-Hearing Reply Brief at 2-3). The

Commission disagreed, finding that APS's analysis demonstrated that its proposal "would provide 'unique value' to its customers, both from an environmental and rate impact standpoint." Decision No. 73130 at 32. Indeed, "[c]ontrary to the Sierra Club's argument, [the Commission confirmed that] APS did consider the financial risks of its coal generation exposure in its analyses and even considering those risks, the evidence showed that the proposed transaction resulted in a 'clear and significant discount.'" *Id.*

In the Commission's April 2012 decision authorizing the SCE Transaction, the Commission made clear its understanding that APS's plan to add pollution control equipment to Units 4 and 5 was an essential and integral component of the overall "proposed transaction." *See* Decision No. 73130 at 7 ("*As part of its requested authorization* to acquire SCE's share of Units 4 and 5 and in response to EPA-proposed environmental controls for Four Corners, *APS ... plans to add pollution control equipment to Units 4 and 5 by 2018* (together, 'proposed transaction').") (emphasis added). The Commission thus acknowledged that the obligation to retrofit Units 4 and 5 with SCRs (as the required BART) was an integral part of the acquisition of SCE's interest so that these units could continue to operate post-2018. The Commission authorized the "proposed transaction" including the plan to install costly pollution control equipment, finding it consistent with APS's "Resource Plan and the competitive procurement rules." *See* Decision No. 73130 at 33.

On May 24, 2012, the Commission approved a settlement agreement to resolve much of an APS rate case authorizing revised schedules of rates and charges to be effective on and after July 1, 2012. Section 10 of the settlement agreement provided that the docket would "remain open until December 31, 2013, for APS to file a request to adjust its rates to reflect the rate base and expense effects associated with (1) the acquisition of [SCE's] ownership interest in Four Corners Units 4 and 5, and (2) the retirement of Units 1-3, as well as any cost deferral authorized in the Commission's Decision in the Four Corners acquisition docket … and that rates [be] adjusted only if the [ACC] finds the Four Corners transaction to be prudent." Decision No. 73183 at 15

(May 24, 2012) Ariz. Corp. Comm'n Docket No. E-01345A-11-0224 (*In the Matter of the Application of Arizona Public Service Company*) (hereinafter "Decision No. 73183").On December 30, 2013, APS closed on the acquisition of SCE's interest in Four Corners Units 4 and 5 and filed with the Commission an application seeking approval of the Four Corners rate rider to reflect its prudent acquisition of SCE's interest in Units 4 and 5, and retirement of Units 1-3, in rates. As previously acknowledged by the Commission, included in APS's decision to make this acquisition was the near-term obligation to comply with federal environmental law by retrofitting Units 4 and 5 with emissions control technology as deemed acceptable by the EPA (i.e., SCRs as the required BART). *See* Decision No. 73130 at 3, 7. Additionally, on December 30, 2013, APS submitted a Form 8-K to the United States Securities and Exchange Commission disclosing its closing of the SCE Transaction and the fact that on that very day "APS, on behalf of the co-owners, notified EPA that they [had] chosen the alternative BART compliance strategy requiring the permanent closure of Units 1, 2, and 3 by January 1, 2014 and installation and operation of [SCRs] on Units 4 and 5 by July 31, 2018."

But for APS's agreement with the EPA, the Company would have had to retire each generating unit at Four Corners no later than 2016. To comply with EPA mandates under the Clean Air Act and continue operating Four Corners beyond 2016, APS and the other joint owners had no choice but to install the BART deemed acceptable by the EPA–the SCRs Investment.

Shortly after APS closed on the acquisition of Units 4 and 5, thereby committing to install BART equipment at those units, the Commission commenced hearings to consider APS's Four Corners rate rider application. The Sierra Club opposed APS's application and alleged that APS's acquisition of SCE's interest was imprudent, asserting that APS "provided insufficient information regarding projected capital expenditures at Units 4 and 5." *See* Decision No. 74876 at 10, 12. Despite this claim, however, APS's actual capital cost estimates associated with the SCRs Investment were part and parcel of the evidence Sierra Club filed in the Four Corners rate rider proceeding. Sierra Club's witness, Ezra Hausman, recounted APS's expected capital cost expenditures of the SCRs Investment, which then reflected an estimate of $365.6 million. *See* Ex. 5 of Test. of Ezra Hausman, Docket No. E-01345A-11-0224 (June 18, 2014) (citing APS response to Staff Discovery Request No. 35.35 at 2 of 7).

On June 19, 2014, Commission Staff presented pre-filed testimony by their independent consultant, James Letzelter ("Letzelter") of The Liberty Consulting Group, who reviewed the analytics behind APS's acquisition of SCE's interest in Units 4 and 5 and found it to be prudent. Letzelter Testimony at 1. Letzelter also published a report, attached as Exhibit A to his testimony, in which he reviewed the four options that APS had identified for the future of Four Corners and how the Company had evaluated those options to arrive at its decision to close Units 1-3 and purchase SCE's interests in Units 4 and 5:

> Based on the opportunity to purchase SCE's share of Units 4 and 5 and the EPA requirements, APS identified four options for the future of Four Corners:
>
> - Continued operation of Units 1, 2, and 3 with Units 4 and 5 shut down in 2016.
> - Replacement of the APS interest in Four Corners with combined-cycle gas generation.
> - Retirement of Units 1, 2, and 3 early and acquisition of SCE's interest in Units 4 and 5.
> - Continued operation of Units 1-3 with SCE's interest in Units 4 and 5 acquired by another party.
>
> APS found that, considering the costs of installing the equipment required to meet BART, the third alternative would produce revenue requirements (on a net present value basis) of about $500 million less than those of combined cycle installation and $1 billion less than those of continued operation of Units 1, 2, and 3.

Letzelter Report at 3.

Mr. Letzelter also reviewed APS's supply and demand situation for electric generating capacity and estimated reserve margins in three of the above-mentioned scenarios. In his review of APS's preferred option, Letzelter found that in years 2014-2016 APS, would have excess capacity, but that the reserve margin would diminish at a reasonable rate and, by 2017, the supply plan would produce a near-optimum annual reserve margin that would be necessary to maintain system integrity until at least 2023. Letzelter Report at 5.

"In Decision No. 74876 (December 23, 2014), issued in the 2011 Rate Case, the Commission found that APS's acquisition of SCE's interest in Units 4 and 5 was prudent and that rate recovery pursuant to the settlement agreement adopted by Decision No. 73183 was appropriate." Decision No. 78317 at 49:4-6 (citing Decision No. 74876 at 46). Similar to Decision No. 73130, the Commission again rejected the Sierra Club's arguments and instead agreed with Mr. Letzelter who "vigorously tested the validity of APS's analytical approach and the data and models APS used[,]" finding that the acquisition of SCE's ownership interests in Four Corners Units 4 and 5 (which necessarily entailed the future installation of costly emissions control technology) was prudent and the requested rate recovery appropriate. Decision No. 74876 at 19. The Commission expressly based its prudence determination on its findings that the proposed SCE Transaction provided direct and indirect benefits, including "preservation of more stable rates and *protection of the existing investment in Units 4 and 5*, as opposed to new investment in gas-fired generation." *Id*. (emphasis added).

On August 18, 2017, the Commission authorized APS "to defer for possible later recovery through rates, all non-fuel costs … of owning, operating, and maintaining the Selective Catalytic Reduction environmental controls at the Four Corners Power Plant." Decision No. 76295 at 22-23 (Aug. 18, 2017) Ariz. Corp. Comm'n Docket No. E-01345A-16-0036, *et al.* (*In the Matter of the Application of Arizona Public Service Company*) (hereinafter "Decision No. 76295"). Unit 5's SCR entered service in December 2017, and Unit 4's SCR entered service in April 2018.

Finally, on April 27, 2018, APS filed with the Commission an application for approval of an SCR Adjustment requesting approval of an annual revenue requirement for its share of the costs of the SCRs. On June 13, 2018, the Sierra Club's Application for Leave to Intervene was granted; however, the Sierra Club subsequently withdrew its intervention on August 10, 2018 and did not participate in the hearings after the Administrative Law Judge (2018) limited the scope of the proceeding to the prudence to the SCRs project and would not permit hindsight review of the SCE Transaction or "the continued running of the Four Corners plant." Tr. of Procedural Conference at 34, Docket No. E-01345A-16-0036 (Jul. 10, 2018). In September 2018, the Commission held hearings considering APS's request for an SCR Adjustment and heard evidence in support of and opposition to a satisfactory prudence determination. On November 27, 2018, a ROO issued recommending a finding "[b]ased on the testimony and evidence presented, … that the SCR project was completed in a cost-efficient, reasonable and prudent manner and that the fair value rate base associated with APS's ownership interest is $383.096 million." Recommended Opinion and Order (SCR Adjustor) at 10 (Nov. 27, 2018) Ariz. Corp. Comm'n Docket No. E-01345A-16-0123 (hereinafter "2018 ROO"). The Commission has never voted on the 2018 ROO.

These decisions reflect the Commission's fully informed determination that acquiring Units 4 and 5 and incurring the necessary costs to install SCRs to bring those units into environmental compliance (based on EPA's BART determination) was a prudent investment. The Commission expressly acknowledged that any decision to acquire SCE's share of Units 4 and 5 of Four Corners would necessarily entail a substantial investment in BART in order for the units to continue operating. The Commission was equally aware of the estimated cost of that investment ($365.6 million) *see supra* at 15, which was very close to the amount of the SCRs Investment that APS sought to recover in the 2018 proceeding ($383.096 million, apart from deferrals), within less than five percent. Had there been any doubt as to the prudence of these future, necessary investments, the initial purchase of SCE's 48% interest in Units 4 and 5 would have made no economic sense. Yet the Commission unambiguously approved the transaction, and in doing so necessarily expressed its understanding that the entire plan—

including the pollution control installation at a cost roughly in line with the cost that APS now seeks to recover, i.e., the SCRs Investment—was prudent.[6]

C. Decision No. 78317 Is Arbitrary and Contrary to Law Because It Adopts a New Prudence Standard That Violates the Commission's Own Regulation and Then Applies It Retroactively to Deprive APS of Its Reasonable Investment-Backed Expectations.

The disallowance of a substantial portion of APS's reasonable used and useful SCRs Investment rests directly on the Commission's newfound "belie[f]" that for purposes of the prudence inquiry, "a utility has a duty to monitor the economics of its investments in a project from the inception of the project and until the project is completed and that each investment made along the way is subject to a prudency determination." Decision No. 78317 at 112:17-19. Indeed, the Commission announces a new "conclusion[] of law" that it is "inconsistent with [a utility's] duties as a regulated utility," and a just basis for denying full recovery of an investment, if the utility "did not monitor the economics of its investments" and "was not open to changing its course once" the project began. *Id*. at 428 ¶ 4:14-17 (capitalization altered). According to the Decision, APS failed to comply with this newly fashioned "duty," in that it allegedly "did not monitor the economics of its investments in the SCRs project after the project commenced and was not open to changing its course once the SCRs project had begun…" *Id*. Ultimately, the Commission based its disallowance of $215.5 million in SCRs Investment costs expressly on this rationale, concluding that "it is just and reasonable and in the public interest to authorize APS to include in rate base the SCRs investments, … with the exception of $215.5 million *based on a finding of planning imprudence*." *Id*. at 116:22-24 (emphasis added).

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[6] In fact, the only matter set aside for future inquiry was whether APS's already-approved decision to install SCRs was "appli[ed]"—i.e., implemented—prudently and in a manner consistent with the Commission's authorization of the project. *See* Decision No. 76295 at 108 ("Nothing in this Decision shall be construed in any way to limit this Commission's authority to review the entirety of the project and to make any disallowances thereof due to imprudence, errors or inappropriate application of the requirements of this Decision.").

This newly created "duty" that utilities must reassess prudence with each new expenditure for an ongoing investment project before they may fully recover their investment has been fashioned out of whole cloth, in an improper attempt to justify denying APS just and reasonable compensation for its used and useful SCRs Investment. The supposed "duty" is not set forth in any statute, regulation, or pertinent Commission precedent. Instead, the Commission's new approach to prudence expressly conflicts with the Commission's long-standing prudence regulation, Ariz. Admin. Code R14-2-103(A)(3)(l). Moreover, the Commission has never previously informed APS nor any other utility that they are subject to such a duty and may be denied full recovery of their investments for failing to comply. Instead, the Commission has retroactively penalized APS's shareholders to the tune of $215.5 million for failing to fulfill this previously unidentified "duty." It is difficult to imagine a more glaring example of arbitrary, unjust, unreasonable, and unlawful agency decision-making.

Arizona law is clear that whether an investment is prudent must be evaluated based on "all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." Ariz. Admin. Code R14-2-103(A)(3)(l). Until this Decision, the Commission's consistent practice had been to conduct the prudence inquiry on a total project or total investment basis.[7] Notably, the

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[7] *See, e.g.*, *Bermuda Water*, Decision No. 77976 (Apr. 29, 2021), Ariz. Corp. Comm'n Docket No. W-01812A-20-0109 (*In the Matter of the Application of Bermuda Water Co.*) (staff reviewed five Post-Test Year Plant projects and concluded that the projects were prudently procured and used and useful in the company's provision of water service to customers); *Tucson Elec. Power Co.*, Decision No. 77856 (Dec. 31, 2020), Ariz. Corp. Comm'n Docket No. E-01933A-19-0028 (*In the Matter of the Application of Tucson Elec. Power Co.*) [hereinafter *Tucson Elec. Power Co.*] (hereinafter "Decision No. 77856") (based on the totality of the evidence, the ACC found Tucson's acquisition of Gila 2 and the RICE units reasonable and prudent and that the facilities are used and useful); *Chaparral City Water Co.*, Decision No. 74568 (June 20, 2014), Ariz. Corp. Comm'n Docket No. W-02113A-13-0118 (*In the Matter of the Application of Chaparral City Water Co.*) (the acquisition costs were allowed because the acquisition was a prudent means for Chaparral to guarantee continued access to adequate renewable water supplies, providing an assurance that benefits both current and future customers); *Tucson Elec. Power Co.*, Decision No. 73912 (June 27, 2013), Ariz. Corp. Comm'n Docket No. E-01933A-12-0291 (*In the Matter of the Application of Tucson Elec. Power Co.*) (Tucson is required to demonstrate that the

timing of APS's SCRs Investment occurred when the SCE Transaction closed on December 31, 2013, or at the latest, on August 20, 2015, when APS executed construction contracts and entered into the EPA consent decree for the SCRs. Under that longstanding approach, the proper point in time for assessing the prudence of APS's decision to make the SCRs Investment is December 30, 2013 (when APS closed on the SCE Transaction and thus assumed the obligation to install the SCRs), or at the very latest August 2015 (when APS executed the SCRs construction contract and entered the EPA consent decree).Indeed, in contrast to its treatment of APS in this proceeding, the Commission applied the total investment standard just last year in authorizing Tucson Electric Power Company ("TEP") to receive full cost recovery for its portion of the SCRs Investment. The Sierra Club challenged TEP's investment in Four Corners, requesting "that the Commission disallow recovery of test year capital costs" at the Plant "until the Company has presented rigorous analysis justifying the continued operation of those plants." *Tucson Elec. Power Co.,* Decision No. 77856 at 46. But the Commission rejected this argument, reasoning that Sierra Club "ha[d] not presented any factual or legal basis to support a finding that TEP's investment in … Four Corners was imprudent at the time it was made." *Id*. at 47, 196. The Commission thus allowed TEP full recovery for its test year capital costs, which necessarily included the SCRs Investment that TEP made jointly with APS.[8] Rather than place the burden on TEP to conduct and present to the Commission a "rigorous analysis justifying the continued operation of those plants," *id*. at 46, the Commission followed its regulations by judging TEP's investment "at the time it was made," *id*. at 47.

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environmental controls were government-mandated and represented a reasonable and prudent option available to Tucson at the time sufficient to meet environmental requirements); *Litchfield Park Serv. Co.*, Decision No. 72026 (Dec. 10, 2010), Ariz. Corp. Comm'n Docket No. SW-01428A-09-0103, *et al.* (*In the Matter of the Application of Litchfield Park Serv. Co.*) (deeming the entire cost of the plant upgrades to be a prudent expenditure and allowing such to be included in rate base); *see generally* Attachment A, *infra* (summarizing the Commission's pertinent decisions on this issue).

[8] In its November 7, 2013 Form 10-Q Report to the Securities Exchange Commission at 23, TEP estimated its share of the capital costs to install SCR technology on Units 4 and 5 at approximately $35 million and incremental annual operating costs for the SCRs at $2 million.

The Commission has never opened a rulemaking docket or otherwise taken formal action to inform regulated utilities that they have a duty to continually reexamine the prudence of an ongoing investment project after the decision to proceed with the project has been made, or that the procedural failure to engage in such continual reexamination is itself a basis for disallowance of recovery of and on a used and useful investment – notwithstanding the total absence of evidence that an alternative investment option actually exists. Decision No. 78317 thus abandons the Commission's rule and long-settled practice without warning, without justification, and without even acknowledging the change of position. Moreover, the Decision fails to address or justify the unjustly and unreasonably penal nature of changing its approach after APS had invested nearly half a billion dollars in used and useful equipment in reliance on the Commission's past approvals and longstanding precedent. The Commission's newfound approach violates its own regulation, well-established prohibitions against retroactive decision-making, and fundamental principles of administrative law, and must be reconsidered and overturned.

1. The Commission's Reliance on Its Newly Fashioned "Duty" to Continually Reexamine the Prudence of Ongoing Investments Is Contrary to Law Because It Violates the Commission's Own Regulation.

"[A]s a general principle of administrative law, 'an agency must follow its own rules and regulations; to do otherwise is unlawful.'" *McKesson Corp. v. Ariz. Health Care Cost Containment Sys.*, 230 Ariz. 440, 443 (App. 2012) (quoting *Clay v. Ariz. Interscholastic Ass'n*, 161 Ariz. 474, 476 (1989) (en banc)). Decision No. 78317's disallowance of APS's investment for alleged failure to comply with the Commission's new "duty" to continually reexamine prudence is irreconcilable with the Commission's own regulation and therefore is unlawful in four respects.

First, the new rule that recovery may be denied for "planning imprudence" is inconsistent with the regulation, which makes clear that the only relevant question for purposes of the prudence inquiry is whether the investment was prudent. The rule expressly provides that all "*[i]nvestments* which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful" are prudent. Ariz. Admin. Code R14-2-103(A)(3)(l) (emphasis added). It further provides that "[a]ll *investments* shall be presumed to have been prudently made," absent "clear and convincing evidence that such *investments* were imprudent…" *Id.* (emphases added). Thus, the rule makes clear that the prudence inquiry is focused solely on the objective question of whether the "investment" itself was prudent in light of the known or reasonably ascertainable conditions at the time of the Decision. The rule says nothing about the mechanism by which the utility decided to make the investment or about whether or how the utility did or did not reexamine the wisdom of the investment after commencing construction.

The Commission's new rule, by contrast, ignores the dispositive issue of the prudence of the investment itself, and instead focuses on a different question, namely, whether the utility engaged in an ongoing reassessment of the prudence of the investment in a manner deemed sufficient (after the fact) by the Commission. Nothing in the regulatory definition authorizes that shift of focus in the prudence analysis. To the contrary, if the *investment* is prudent and used and useful, it must be included in the rate base, without regard to whether the utility continually reconsidered the investment to the satisfaction of the Commission. Ariz. Admin. Code R14-2-103(A)(3)(h). Thus, the Commission has impermissibly substituted a procedural duty (to conduct ongoing prudence reviews) for the substantive standard imposed by the rule, which looks only to the prudence of the investment itself. This, the Commission cannot lawfully do.

Second, the Commission's new focus on so-called "planning imprudence" also violates the presumption of prudence and the allocation of the burden of proof mandated by the regulation. By inventing and imposing this new "duty," the Commission effectively shifts the burden from those challenging the investment to APS, requiring APS to come forth with evidence documenting that its decision-making process was adequate to support the investment. The Commission has thus claimed the right to make a finding of imprudence despite the absence of any evidence (let alone clear and convincing evidence) that the investment was imprudent at the relevant point in time. Imprudence is defined in the regulation as "dishonest or obviously wasteful," but there is no sense in which a mere failure to reexamine prudence with each additional project expenditure is necessarily "dishonest" or "obviously wasteful" merely because the Commission believes that the utility failed to reconsider the investment on a sufficiently frequent basis or with a sufficiently open mind. *See* Ariz. Admin. Code R14-2-103(A)(3)(l). To the contrary, any such assumption is simply irreconcilable with the principle that "[a]ll investments shall be presumed to have been prudently made." *Id.* If the investment's prudence is presumed, then the mere failure to conduct a new prudence inquiry cannot change the fact that the investment is presumptively prudent. The presumption as to prudence only has meaning if investments are actually deemed prudent by the Commission without the utility needing to re-establish the presumed fact of prudence each step along the way. Rather, actual evidence sufficient to demonstrate that the investment has become "dishonest or obviously wasteful" is necessary to overcome the presumption, and there is no basis for eviscerating the presumption of prudence merely because the utility has not continually re-established the prudence of the investment. The Commission's new rule effectively constitutes a presumption of imprudence unless the utility has affirmatively established the investment's prudence with each new expenditure. The Commission's new "duty" is precluded by the regulatory presumption.

Third, the Commission's new rule also violates the regulation's prohibition against applying hindsight to the issue of prudence. *See* Ariz. Admin. Code R14-2-103(A)(3)(l) (investments' prudence must be "viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, *at the time such investments were made*") (emphasis added). Long after a utility has prudently decided to commence a major new construction project, the Commission's new approach permits the project to be disallowed at a much later point if the Commission determines that the utility was not sufficiently diligent in reconsidering the prudence issue at a much later point in time. The Decision confirms this impermissible breach of the regulation by citing extensively to hindsight evidence. *See* Decision No. 78317 at 113-17.

Fourth, the Commission's new rule constitutes impermissible managerial interference by the Commission with the day-to-day operations of APS. The Arizona Supreme Court has held that "the commission has no authority or jurisdiction to control the internal affairs of the corporation." *Corp. Comm'n v. Consol. Stage Co.*, 63 Ariz. 257, 263 (1945). This "managerial interference doctrine" is "designed to protect regulated corporations from over-reaching and micro-management of their internal affairs by the Commission." *Miller v. Ariz. Corp. Comm'n*, 227 Ariz. 21, 27 ¶ 23 (App. 2011). *Cf. Johnson Util's LLC v. Ariz. Corp. Comm'n*, 246 Ariz. 287, 291 ¶ 14 (2019) (vacated on other grounds) ("rules that attempt to control the corporation . . . are impermissible"). The Commission's new rule violates this doctrine. As noted, it requires that the utility conduct a "prudency determination" with each new expenditure "from the inception of the project and *until the project is completed*." Decision No. 78317 at 112:18 (emphasis added). Such a mandate regarding the day-to-day actions of the utility is the epitome of unlawful managerial interference, and amounts to Commission micro-management of the internal affairs of APS.

In all these ways, the Commission has failed to follow its own rules, in violation of law. Its disallowance of $215.5 million in APS's reasonable expenditures on the SCRs Investment should therefore be reconsidered and reversed.

2. Retroactive Application of the Commission's New Prudence Standard Is Contrary to Law and Violates Due Process Because It Deprives APS of Its Reasonable Investment-Backed Expectations.

Retroactive application of a new agency policy is impermissible under the law when, as here, it was not reasonably anticipated and upsets the regulated party's reasonable investment-backed expectations. APS made its SCRs Investment in reasonable reliance on the Commission's regulations and its longstanding approach to prudence determinations, as well as the Commission's prior decisions approving the Four Corners acquisition and subsequently deeming that acquisition prudent (expressly including the planned installation of emissions-control equipment, i.e., the SCRs Investment). Against this backdrop, retroactive application of the Commission's new prudence standard in this proceeding is entirely unlawful.

The Commission's new approach to assessing planning imprudence departs from the Commission's prior policies in at least four ways.

First, the standard is inconsistent with the Commission's prior decisions and conclusion in approving the SCE Transaction. As discussed in Section III.B. above, in 2012 the Commission authorized APS's "proposed transaction," defined as: (1) acquisition of SCE's share of Units 4 and 5; (2) accelerated retirement of Units 1, 2, and 3; and (3) addition of the SCRs to Units 4 and 5 by 2018. *See* Decision No. 73130 at 7. In 2014, the Commission found this same transaction prudent, again recognizing that it necessarily encompassed APS's decision to make the SCRs Investment to permit the ongoing operation of the Plant. *See* Decision No. 74876 at 43. Indeed, the Commission expressly found that the transaction would "help ensure the continued provision of reliable and reasonably priced electricity for APS's customers." *Id.* In its assessment of the SCE Transaction, Staff found a 99.4%chance that the SCE Transaction would have a positive net present value, with 90% confidence that the net present value would be between $97 million and $512 million. *Id.* at 17 (citing Direct Test. of Comm'n Staff witness James Letzelter, Hr'g Ex. S-1, attached Liberty Report at 13 and Tr. Vol. III at 587-88 (Aug. 6, 2014)).[9] Moreover, this assessment was expressly based upon capital cost estimates for the SCRs Investment that were within less than five percent of the actual project costs. *See supra* Section II.B.

APS reasonably relied on these Commission decisions, and on the Commission's longstanding rule and approach to evaluating prudence based on an examination of the overall project, in proceeding to retrofit Units 4 and 5 with the SCRs. Decision No. 78317 does not purport to overturn these prior Commission decisions. Moreover, the Decision

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[9] The Administrative Law Judge (2019) took official notice of the transcripts from the proceeding that resulted in Decision No. 74876, and as such they are a part of the evidentiary record of this case. *See* Decision No. 78317 at n.187.

does not in any way identify a basis for concluding that it was unreasonable for APS to rely on these decisions in making future investment choices.

Second, the Commission's approach and conclusion is inconsistent with its allowance of full cost recovery to TEP of the same investment. The Commission found TEP's test year capital costs in Four Corners—which included TEP's share of the SCRs Investment—prudent because Sierra Club failed to present evidence that the investment "was imprudent at the time it was made." *Tucson Elec. Power Co.*, Decision No. 77856 at 47. Here, by contrast, the Commission imposed an additional planning prudence duty on APS, which shifted the burden to APS to rigorously analyze and demonstrate to the Commission that each stage of its SCRs Investment was prudent. By applying an inconsistent method, the Commission reached an inconsistent result, finding the same investment imprudent when made by APS and prudent when made by TEP—thus denying partial cost recovery to APS when the Commission had previously allowed full cost recovery to TEP for an investment in the same project.

Third, the novel approach to assessing planning imprudence is incompatible with the Commission's longstanding practice of evaluating prudence on a total investment basis. *See supra* at 20-21 & n.7. Rather than assessing the prudence of the total investment "at the time such investments were made," Ariz. Admin. Code R14-2-103(A)(3)(l), the Commission found that APS should have reassessed each expenditure throughout project development for the SCRs and should continue to do so for the entire operational life of the project (i.e., for so long as the Company invests capital into the SCRs in order to ensure they remain operational). The Commission never acknowledged that this new approach was a change from longstanding policy and practice, and it never considered APS's reliance on the Commission's prior approach or identified any basis for concluding that APS acted unreasonably in relying on that approach.

Fourth, Decision No. 78317 imposes a novel duty on APS with no precedent in the Commission's prior decisions and without advance notice to APS. The Decision does not even acknowledge its change of practice in this regard, much less identify any way APS could have prophesied in advance that the Commission would require it to reassess an investment that the Commission itself had already approved, let alone be subject to a duty of continued reassessment throughout the life of the project.

Under these circumstances, the law precludes retroactive application of this novel "duty" on APS as a basis for denying full recovery of and on its SCRs Investment. Under Arizona law, a "statute that is merely procedural may be applied retroactively," but it may not "attach[] new legal consequences to events completed before its enactment" or "disturb vested substantive rights by retroactively changing the law that applies to completed events." *San Carlos Apache Tribe v. Superior Court ex rel. Cty. Of Maricopa*, 193 Ariz. 195, 205 (1999) (en banc). Laws that "retroactively alter vested substantive rights violate the due process clause." *Id*. The same is true of regulations. *See George v. Ariz. Corp. Comm'n*, 83 Ariz. 387, 390-91 (1958); *Taylor v. McSwain*, 54 Ariz. 295, 312 (1939) ("Retroactive regulations are just as obnoxious as retroactive laws … we think the whole spirit of our government is opposed thereto, and unless the legislative authority expressly declares regulations may be retroactive, it is beyond the power of a commission or subordinate body to give them that effect.").

With respect to adjudicative decisions, Arizona courts apply a three-factor test to determine whether an adjudication should be given "prospective application only." *Mark Lighting Fixture Co. v. Gen. Elec. Supply Co.*, 155 Ariz. 27, 30 (1987) (en banc). These factors are: "(1) Whether the decision establishes a new legal principle by either overruling clear and reliable precedent or deciding an issue whose resolution was not clearly foreshadowed; (2) Whether retroactive application will further or retard operation of the rule, considering its prior history, purpose and effect; and (3) Whether retroactive application will produce substantial inequitable results." *Id.*

The first factor focuses on the foreseeability of an opinion's new legal rule. Here, it was plainly not foreseeable that the Commission would change its longstanding practice and adopt a new approach to prudence determinations, or that it would do so through adjudication in APS's rate case instead of following the notice and comment rulemaking procedures it is required to utilize under Ariz. Rev. Stat. § 41-1001 *et seq*. when it seeks to revise its regulations. That lack of foreseeability is further heightened here by the fact that APS reasonably relied on the Commission's prior prudence determination with respect to Units 4 and 5, which would have been meaningless if it had not recognized (as it did) that the SCRs were essential to the continued operation of those units.

A new rule is not foreseeable when no prior decisions "even broach[ed] the subject..." *Hawkins v. Allstate Ins. Co.*, 152 Ariz. 490, 504 (1987) (holding that the first factor "strongly favor[ed] prospective-only application" of precedent that changed the burden of proof when no prior decisions "even broache[d] the subject of a higher burden of proof"). That is plainly the case here.

The second factor asks "[w]hether retroactive application will further or retard operation of the rule, considering its prior history, purpose and effect[.]" *Mark Lighting*, 155 Ariz. at 30. Here, the Commission has not explained whether its new "duty" to avoid what it calls "planning imprudence" is a rule of general application or is instead a rule fashioned for this case only.[10] Regardless, the Commission has failed to articulate any purpose for creation of this new rule other than its desire to disallow a substantial portion of APS's investment, and it is difficult to imagine any valid justification for retroactive application of a rule calling for constant reexamination of prudence on an ongoing basis. By definition, the retroactive application of such a rule can do nothing to change conduct that has already occurred, and retroactive application is completely unnecessary to change conduct on a going-forward basis.

The third factor, inequity, "focuses on the injustice or hardship that would result from retroactive application of the new rule." *Fain Land & Cattle Co. v. Hassell*, 163 Ariz. 587, 597 (1990) (en banc). The *Fain Land* court created a new rule for the disposal of state lands. Because the rule would affect "[s]everal hundred" previously completed

[10] As explained in Part II.C.4 *infra*, under either view the Commission's ad hoc attempt to adopt a new rule failed to comply with the notice and comment rulemaking procedures of Ariz. Rev. Stat. § 41-1001 et seq. and constitutes an arbitrary and discriminatory violation of APS's constitutional right to just and reasonable ratemaking.

land exchanges, "inflict great hardship on many innocent people, and perhaps disrupt the economy of the state," the court declined to apply the rule retroactively. *Id*. Inequities also arise when a new rule subjects a party to additional claims in "cases [it] previously believed had been finalized." *Wiley v. Indus. Comm'n*, 174 Ariz. 94, 104 (1993) (en banc) (internal quotations omitted) .

The principle in *Wiley* is directly applicable here. The Commission's existing rule and prior decisions gave APS ample reason to believe that the Commission had already confirmed the need for the SCRs Investment by finding Four Corners to be prudent and beneficial while recognizing that the SCRs were essential to achieve the benefits of continued operation of Four Corners. And the Commission's regulations and prior approach to prudence determinations more generally gave APS every reason to anticipate that even if the prudence of the SCRs Investment had not already been determined, it would be assessed on a total investment basis without application of an unknown duty to conduct an expenditure-by-expenditure prudence analysis on an ongoing basis. Under *Fain Land* and *Wiley*, inequity prohibits this retroactive application of the Commission's new approach to assessing planning imprudence because of the injustice that results. That is particularly true here because the Commission's disallowance imposes significant economic harm on APS and ultimately its customers, as detailed by the testimony of APS witnesses.[11] As APS's President/CEO explained, the disallowance of recovery for the SCRs based upon hindsight threatens the Company's ability to access capital on reasonable terms for future capital projects.[12]

Independent of the limitations on retroactive rulemaking, moreover, due process requires at a minimum that an agency give regulated entities "fair warning of the conduct it prohibits or requires." *Gates & Fox Co. v. OSHRC*, 790 F.2d 154, 156 (D.C. Cir. 1986). "In the absence of notice—for example, where the regulation is not sufficiently clear to

[11] *E.g.,* Ex. APS-5 (Guldner Rebuttal) at 4; Ex. APS-6 (Guldner Rejoinder) at 4; Tr. Vol. VIII at 1719-21 (Jan. 26, 2021) (Shipman); Spec. Open Mtg. Tr. Vol. III at 561, 628-633 (Jan. 19, 2021) (Guldner).

[12] Spec. Open Mtg. Tr. Vol. III at 561, 628-633 (Oct. 6, 2021) (Guldner) .

warn a party about what is expected of it—an agency may not deprive a party of property," as the Commission has done here by disallowing recovery of a substantial portion of APS's investment. *Gen. Elec. Co. v. U.S. EPA*, 53 F.3d 1324, 1328-29 (D.C. Cir. 1995), *as corrected* (June 19, 1995). This requirement—which "has now been thoroughly 'incorporated into administrative law'"—"'compel[s] clarity' in the statements and regulations setting forth the actions with which the agency expects the public to comply." *Id.* By imposing a new duty with no precedent in prior agency decisions and no clear source in the Commission's regulations, the Commission thus violated APS's right to due process.

Based on review of the foregoing, the Commission's new approach to assessing planning imprudence cannot be applied retroactively to APS without violating due process. The Commission's disallowance of a substantial portion of the SCRs Investment must therefore be reconsidered and reversed.

3. Applying This New Legal Standard to Deprive APS of Its Reasonable Investment-Backed Expectations Without Acknowledging and Providing a Reasoned Justification for the Policy Change Is Arbitrary and Capricious.

As noted above, in announcing this new "duty" to reexamine prudence with each new expenditure, the Commission never acknowledged that it was changing its approach from its prior practice, nor did it even attempt to justify that change of approach, consider the reliance interests in the prior approach, or explain why retroactive application of its new standard to APS in this case was just and reasonable. The Commission's conduct, therefore, constitutes arbitrary and capricious agency decision-making.

Under well-established principles of administrative law, "the requirement that an agency provide reasoned explanation for its action" "…ordinarily demand[s] that it display awareness that it *is* changing position. An agency may not, for example, depart from a prior policy *sub silentio* …. And of course the agency must show that there are good reasons for the new policy." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009); *see also Sw. Airlines Co. v. FERC*, 926 F.3d 851, 856 (D.C. Cir. 2019) ("A full and rational explanation becomes especially important when… an agency elects to shift its policy or depart from its typical manner of administering a program." (alterations accepted) (internal quotation omitted)). Similarly, while an agency need not demonstrate that its new policy is better than the old one, it must at least "acknowledge [those] precedents" and then either "distinguish them" or explain its "rejection of their approach." *Tenn. Gas Pipeline Co. v. FERC*, 867 F.2d 688, 692 (D.C. Cir. 1989). The agency must also "take account of legitimate reliance on [its] prior interpretation[s]" and policies. *Smiley v. Citibank (South Dakota), N. A.*, 517 U.S. 735, 742 (1996). Failure to do so may be "'arbitrary, capricious,'" or "'an abuse of discretion.'" *Id.* (citing 5 U.S.C. § 706(2)(A)).

Here, the Commission has neither acknowledged its change of practice, attempted to justify it, nor considered APS's reliance interests. Those failures alone render its decision arbitrary and unlawful. But those failures are aggravated here by the fact that the Commission has chosen to apply its new approach retroactively in a manner that divests APS of its reasonable investment-backed expectations. As the U.S. Supreme Court has held, while an "agency need not always provide a more detailed justification" for a change of position "than what would suffice for a new policy created on a blank slate," "[s]ometimes it must—when, for example, … its prior policy has engendered serious reliance interests that must be taken into account." *Fox*, 556 U.S. at 515. Indeed, it "would be arbitrary or capricious to ignore such matters. In such cases it is not that further justification is demanded by the mere fact of policy change; but that a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy." *Id.* at 515-16.

Further, the Commission's inconsistent treatment of APS and TEP is also arbitrary and capricious. In the federal agency context, "disparate treatment of similarly situated entities is prohibited by the Administrative Procedure Act," *Lilliputian Sys., Inc. v. PHMSA*, 741 F.3d 1309, 1313 (D.C. Cir. 2014), because government "is at its most arbitrary when it treats similarly situated people differently," *Etelson v. Off. of Pers.*

Mgmt., 684 F.2d 918, 926 (D.C. Cir. 1982). An agency seeking to draw distinctions between similarly situated entities therefore must ""offer [ ] a [ ] reason for its differing treatment…" *Id.* at 927. But the Commission failed to "articulate[ ] an adequate explanation" for its disparate treatment. *Int'l Fabricare Inst. v. EPA*, 972 F.2d 384, 389 (D.C. Cir. 1992).

For these reasons as well, the Commission's disallowance of a substantial portion of APS's SCRs Investment is unlawful and should be reconsidered and reversed.

4. The Commission Improperly Modified Its Regulations and Imposed a New Rule Without Following the Proper Rulemaking Procedures.

The Commission's creation of a new "duty" is also procedurally improper because the Commission cannot modify its regulations or create new rules without engaging in the rulemaking procedures required by the Arizona Administrative Procedure Act ("APA"). "Under the APA, administrative rules must be promulgated pursuant to certain procedural standards." *Carondelet Health Serv., Inc. v. Ariz. Health Care Cost Containment Sys. Admin.*, 182 Ariz. 221, 226 (App. 1994) (citing Ariz. Rev. Stat. §§ 41-1021 to 41-1035). "APA rulemaking requires public notice, and the opportunity for public participation and comment, to ensure that those affected by a rule have adequate notice of the agency's proposed procedures and the opportunity for input into the consideration of those procedures." *Id.* These requirements apply equally to the Commission. *Ariz. Pub. Serv. Co. v. Ariz. Corp. Comm'n*, 155 Ariz. 263, 270 (App. 1987), *vacated and rev'd in part on other grounds*, 157 Ariz. 532 (1988).

Here, the Decision effectively imposes a new rule. There is no precedent for the Commission's statement that "a utility has a duty to monitor the economics of its investments in a project from the inception of the project and until the project is completed and that each investment made along the way is subject to a prudency determination." Decision No. 78317 at 112:17-19. And that statement meets the APA's definition of a "rule" as "[a]n agency statement of general applicability that implements, interprets or prescribes law or policy, or describes the procedure or practice requirements of an agency." Ariz. Rev. Stat. § 41-1001(21). The statement is one of "general applicability," and it "prescribes law," *id.*, by creating a new duty.

The Commission was thus required to undergo rulemaking. Indeed, that requirement was particularly important because the new duty that the Commission announced was contrary to its existing regulations. *See Carondelet*, 182 Ariz. at 227-28 (agency was required to follow rulemaking procedures when changing standards). Because the Commission instead simply announced a new duty contrary to its existing regulations in the course of ratemaking proceedings, it violated the APA.

D. Even Leaving Aside the Fatal Flaws in the Commission's New Prudence Standard, the Commission's Determination of Imprudence Is Arbitrary, Contrary to Law, and Not Supported by Substantial Evidence.

1. The Commission's Finding of "Planning Imprudence" Is Arbitrary and Unlawful.

a. The Decision Improperly Relies on Hindsight in Violation of the Governing Regulation.

Decision No. 78317 is also unlawful, arbitrary and capricious, and unsupported for the additional reason that it impermissibly relies on hindsight to deny APS's request for cost recovery of a substantial portion of the SCRs Investment. The governing regulation is clear that the presumption of prudence controls in the absence of "clear and convincing evidence" that the investments "were imprudent, *when viewed* in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, *at the time such investments were made*." Ariz. Admin. Code R14-2-103(A)(3)(l) (emphases added). Decision No. 78317 violates this unambiguous requirement in multiple fatal respects.

First, and most saliently, the rationale for Decision No. 78317's disallowance of $215.5 million in costs is explicitly framed in hindsight terms. The Decision states that "it is just and reasonable and in the public interest to authorize APS to include in rate base the SCRs investments, … with the exception of $215.5 million *based on a finding of planning imprudence*." Decision No. 78317 at 116 (emphasis added). And immediately after stating this finding, the Commission inserted a footnote to elaborate on the basis for the finding: "One consequence of this planning imprudence is the early retirement of the SCRs. Hence, *the disallowance of $215.5 million is based on the early (2031) retirement of the SCRs*." *Id*. at 116:28 n.189 (emphasis added).

Decision No. 78317 thus makes clear that the disallowance "is based on" the decision to retire Four Corners (and thus the SCRs) in 2031 rather than 2038 as originally projected. But Decision No. 78317 also acknowledges that the decision to retire Four Corners earlier than 2038 *was not made until 2020*, long after the decision to make the SCRs Investment had been made, and indeed long after the SCRs had been completed and were in operation. Decision No. 78317 states that "[u]ntil APS made its Clean Energy Commitment, all indications were that the SCRs would provide … service" from "April 2018 to July 2038." *Id.* at 115:27-28. APS made its Clean Energy Commitment in 2020, *id*. at 112:6-7, and there is no evidence (let alone a purported finding) that APS somehow knew or should have known when it closed the SCE Transaction in 2013 and started construction on the SCRs Investment in 2015 that it was *later* going to make a Clean Energy Commitment that entailed shutting down Four Corners earlier than previously anticipated. Thus, the very basis for the Commission's disallowance decision is an event that occurred long after APS closed on the SCE Transaction and made the SCRs Investment decision, and even well after the project was complete. The Commission's reliance on this subsequent event as the acknowledged basis for disallowing $215.5 million of a reasonable investment in used and useful equipment is an egregious and unambiguous violation of the regulation's prohibition against the use of hindsight in making prudence determinations.

In addition to that fundamental flaw in the Commission's reasoning, Decision No. 78317's discussion of the prudence issue is replete with other impermissible uses of hindsight. For example, Decision No. 78317 states that "*[a]s of the close of record in this matter*, APS had not analyzed the economic costs and benefits of continuing to operate [Four Corners] or the impact on retail rates of a pre-2031 retirement of either or both units of [Four Corners]." *Id*. at 114:4-6 (emphasis added). What APS may or may not have done as of 2021 is irrelevant to a proper, non-hindsight prudence analysis of an investment that APS became obligated to make in 2013 (when it acquired Units 4 and 5) and began constructing in 2015.

Other examples abound. The Commission claims that it relied in part on the assumptions APS made about the use of Four Corners in "its 2020 IRP," *id*. at 114:7, long after the SCRs Investment decision was made.

Decision No. 78317 cites to:

- Four Corners' and other resources' post-construction operating costs (asserting that Four Corners "has become" more expensive whereas other resources "have become" less expensive), *id*. at 114:9-10;[13]
- "Solar PPA prices" through "2019," *id*. at 114:11;
- "Median installed PV project prices" through "2019," *id*. at 114:13;
- Post-construction prices for "wind resources," *id*. at 114:14;[14]
- Post-construction prices for "battery storage," *id*. at 114:15-16;[15]
- Post-construction "Natural gas prices," *id*. at 114:17-18;[16]
- Palo Verde Hub market prices "in 2019" and projections "through 2029," *id*. at 114:19-20;
- Alleged Four Corners cost data "in 2019," *id*. at 114:23;
- APS FERC Form filings through "2019," *id*. at 114:25-26;

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[13] Here, the Commission appears to have relied on data assessed from 2021-2031 by Citizen Groups' witness David Schlissel in his testimony. Ex. CG-6 (Schlissel Direct) at 5 & 26.

[14] This data, which appears to be based on Ex. CG-6 (Schlissel Direct) at 10, analyzes wind price information from 2018, as published in a report in 2019.

[15] This data, which appears to be based on Ex. CG-6 (Schlissel Direct) at 10, reflects battery storage price information from 2018, as published in 2019.

[16] This data, which appears to be based on Ex. CG-6 (Schlissel Direct) at 12, uses gas price data and assumptions for the years 2007-2029 that was downloaded from S&P Global Market Intelligence in September 2020. Given that natural gas prices have nearly doubled in the past year, it is readily apparent that if this data were downloaded again in November 2021, the results would be substantially different. The Commission was well aware of this, but chose to ignore it, which means that even in its use of improper hindsight the Commission chose to take an unbalanced approach.

- Various cost projections "for 2020-2030," *id*. at 114:27-115:3;
- "[C]apacity factor" data through 2019, *id*. at 115:7-9;
- Industry average data for coal-fired plants through 2019 and into 2020, *id*. at 115:10-11; and
- A forward-looking analysis of potential Four Corners retirement filed in this docket by APS in 2020, *id*. at 115: 19-26.

Each of these citations is incontrovertible proof of the Commission's reliance on impermissible hindsight. Decision No. 78317 thus demonstrates repeatedly and incontrovertibly that the Commission has disregarded its legal obligation to base its prudence determination solely on information that was available to APS "at the time such investments were made." Disregard of an agency's own regulation is arbitrary and unlawful and compels reconsideration of the Decision.

The need to install the SCRs was an integral part of APS's decision to initiate the SCE Transaction, given that Units 4 and 5 would have had to shut down by 2018 absent installation of the SCRs. Because of this, the relevant "time" the SCRs Investment was "made" for purposes of assessing the prudency of APS's decision to invest is best viewed as December 30, 2013, when APS acquired Units 4 and 5 and thereby became obligated to install federally required emissions control technology to continue operating Four Corners. *See* Decision No. 74876 at 5. The latest plausible "time" the SCRs Investment could be said to have been "made" would be August 2015, when APS executed, both, the SCRs Engineering Procurement and Construction Agreement with its vendor and a Consent Decree with the EPA agreeing to install the SCRs on Units 4 and 5 by no later than mid-2018. *See* Decision No. 78317 at 89: 13-14, 90:6-7. By August 2015, APS had no other reasonable alternative but to complete the SCRs Investment as clearly envisioned by the Commission in Decision Nos. 73130 and 74876. But the Decision relies extensively and fundamentally on evidence and events arising not only long after the decision to invest was made, but even after the project was complete. This is the starkest form of impermissible hindsight and cannot be permitted to stand.

b. The Commission's Finding of "Planning Imprudence" Does Not Establish the Existence of Clear and Convincing Evidence of Actual Imprudence.

The Commission states that "[c]lear and convincing evidence has been presented that APS did not monitor the economics of its investments in the SCRs project after the project commenced and was not open to changing its course once the SCRs project had begun, both of which were inconsistent with its duties as a regulated utility. Thus, it is just, reasonable, and in the public interest to allow APS only partial recovery for its SCRs investments." Decision No. 78317 at 428:14-18. As shown above, the Commission's reliance on its newly fashioned "duty" as the basis for this conclusion is impermissible. But even setting that fatal flaw aside, the Commission's disallowance on imprudence grounds is separately invalid. The Commission never attempts to explain, and never identifies clear and convincing evidence that would permit it to find, that if a prudence assessment had been conducted at any point during the construction of the SCRs based on the information available at the time, the most cost-effective approach to providing reliable service to APS's customers would have been to cancel the SCRs project, shut down Four Corners in 2018, and make other (unspecified) arrangements to replace the resulting massive loss of generation capacity (i.e., 970 MW for APS customers). This new approach to ratemaking would all but remove meaning that a public utility is entitled to recover the fair value of its used and useful public utility property. Mere "planning imprudence"—in the sense of not constantly reexamining prudence with every expenditure—does nothing to establish *actual* imprudence, in the sense that failing to abandon the SCRs project and shut down Four Corners amounted to "dishonest or obviously wasteful" conduct. *See supra* Section II.C.1.

There is no evidence in the record sufficient to establish by a preponderance, let alone by clear and convincing evidence, that any portion of the Four Corners and the SCRs project was uneconomic at the time the decision to proceed was made relative to then-existing and reliable alternatives. There is uncontroverted evidence that the SCRs project came in under budget and on time. Opinion and Order (SCR Adjustor) at 9, Docket No.

E-01345A-16-0036, *et al.* (Nov. 27, 2018) ("According to [Staff witness] Mr. Grace, the project was completed at a cost of $625 million, which is $10 million less than the projected cost of $635 million. Of the total cost, APS is responsible for 63 percent…based on its ownership interest in Four Corners, or approximately $385 million") (RUCO witness Frank Radigan acknowledged Staff's findings that APS "constructed [the SCRs] in such a short period of time and at cost." *See* Tr. Vol. XX at 4265 (Feb. 19, 2021)). Staff's own expert found the costs of APS's engineering and construction of the SCRs were prudently incurred. *Id*. ("Mr Grace testified that [Critical Technologies Consulting, LLC or] CTC [as it is referred to in much of the 2018 ROO] found that the SCR project was well executed, was completed on schedule at a reasonable cost, and is functioning properly within design requirements.").

As shown in Section III.A. above, moreover, Four Corners (including the SCRs, since Four Corners can only operate in conjunction with its required pollution controls) is essential to the reliability of APS's electric system, and thus to the integrity of the electric grid in Arizona as a whole. The Sierra Club's projections about the purported decrease in costs of renewables and the like does nothing to change that irrefutable fact, because the Sierra Club offered no reliability assessment to validate the efficacy of its analyses; therefore, such analyses cannot be relied upon to support their resource portfolio alternatives.[17] Such analyses were also entirely based upon resources available *today*; no evidence was put into the record suggesting that the Sierra Club resource portfolio contained available resources that APS could have invested in as a more cost-effective

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[17] Sierra Club has raised similar arguments in prior proceedings that the Commission has set aside. For instance, in Decision No. 73130, the Commission found that "the Sierra Club [did not] present[ ] credible evidence to rebut the testimony of APS, WRA/EDF, RUCO, or Staff about the 'unique value' of, or the 'clear and significant discount presented by, the [SCE T]ransaction." Decision No. 73130 at 33. APS's testimony and evidence showed that the SCE Transaction was "good for ratepayers because the purchase price is a 'good deal'; the existing interest in a reliable, low-cost generation asset is preserved; and because the diversity of APS' resource portfolio is maintained." Decision No. 73130 at 40. The Commission has also previously concluded that the SCE Transaction would "ensure the continued provision of reliable and reasonably priced electricity for customers in APS's service territory. The recommendations of the Sierra Club are unnecessary and will not be adopted." Decision No. 74876 at 46.

and reliable alternative to continued operation of Four Corners during the relevant time period (i.e., when the decision to proceed with the SCRs Investment was made, or even thereafter through mid-2018 when the SCRs had to be placed into service). The record establishes that reliance on the Sierra Club's proposed approach would have resulted in blackouts during periods of high demand, precisely the result that APS is obligated to take all reasonable steps to avoid.

The Sierra Club's witness Comings asserted that APS should have considered: (1) abandoning the SCRs project; and (2) simultaneously retiring Units 4 and 5 of Four Corners. Tr. Vol. XIV at 3090 (Feb. 10, 2021). But that assertion simply ignores the adverse consequences of such an approach. First, even if APS had somehow been able to convince the other co-owners of Four Corners to prematurely retire the Plant by or before April 2018 (when the SCRs for Units 4 and 5 commenced used and useful service), each utility's customers would have been confronted with many years of stranded costs based on the remaining life of Four Corners and the years remaining on the Coal Supply Agreement (2031). Second, customers and APS would have been at risk of having to contribute to reimbursing the abandoned plant costs associated with the SCRs Investment that had been incurred prior to the hypothetical decision to abandon the project. Third, APS and the co-owners would have had to replace 1,500 MW of reliable on-demand electric power on their collective systems by 2018, when Four Corners would have been shuttered. There is no evidence sufficient to establish that such an approach would have been possible at the available time, much less that it would have been beneficial and less costly for APS's customers once the cost of acquiring new reliable capacity and the stranded costs of the abandoned investments in Units 4 and 5 had been considered.

In short, Decision No. 78317 does not even claim that the record demonstrates the existence of a specific, feasible, economic, and reliably viable alternative that could have met any reasonable projection of APS's future power needs in time to permit the closure of Four Corners in 2018. Nor does the Decision claim that abandonment of the SCRs, retirement of Four Corners, and construction of replacement generation would have been more cost-effective for customers while also ensuring the reliability of the Arizonan electric system. There is one fundamental reason for these failings: the record compels the conclusion that the SCRs Investment was prudent, and indeed necessary to ensure the reliable, cost-effective provision of electric service to Arizonans.

2. The Commission's Finding of "Intentional Manipulation" Is Arbitrary, Contrary to Law and Not Based on Substantial Evidence.

For the first time, long after the close of the record in the case and via amendment, the Commission on its own accord and without any evidence, much less the clear and convincing evidence required by its own rules, alleged that APS "intentionally manipulated" load forecasts to project an inflated need for generation capacity to maximize the potential for recovery of the SCRs Investment. Decision No. 78317 at 113:7-8; *see also*, Comm'r O'Connor and Comm'r Tovar Amend. No. 1, Docket No. E-01345A-19-0236 (Oct. 27, 2021). No party in the case had made any such allegation, nor did any party submit any evidence to support such an allegation. And the Commission itself failed to identify evidence establishing that APS acted with anything other than complete good faith.

In an attempt to justify this post hoc "finding" of purported misconduct on a ground never raised in the proceeding and completely lacking in record support, the Commission pointed to two prior decisions in which it raised questions about APS's load forecasts. Nothing in Decision Nos. 75068 or 76632 provides any basis for a finding of intentional manipulation, as neither decision makes any such assertion or points to any basis for believing that APS was engaged in intentional manipulation.[18]

In addition, the Commission cites, but misrepresents, the testimony of Staff witness Gurudatta Belavadi ("Belavadi") who questioned APS's forecasted growth in load

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[18] *See* Decision No. 75068 (May 8, 2015) Ariz. Corp. Comm'n Docket No. E-00000V-13-0070 *(In the Matter of Resource Planning and Procurement in 2013 and 2014);* Decision No. 76632 (Mar. 29, 2018) Ariz. Corp. Comm'n Docket No. E-00000V-15-0094 (*Resource Planning and Procurement in 2015 and 2016).*

explaining that he "understands that it is standard utility practice to incorporate a reasonable and realistic system growth for long term planning purposes. However, based upon a review of previous APS load forecasts, [he] believe[d] a revised load forecast [would be] needed." Ex. S-7 (Belavadi Direct) at 12 (Oct. 2, 2020). Nothing in Belavadi's testimony suggests APS engaged in "intentional manipulation" of the load growth assumptions in its IRP load forecasts. Instead, Belavadi testified that "Staff does not believe that the APS forecasted growth in load and demand is likely to occur, based on an analysis of the historical data and the potential impact(s) due to COVID-19 on energy consumption trends." *Id.* at 11. This means simply that Staff does not agree with APS's forecasted load growth in light of anomalous usage conditions that Staff believes are prevalent due to the pandemic. APS submitted its 2020 IRP on June 26, 2020, with only about three-to-four months of usage data observed during the pandemic. The pandemic was unprecedented and inherently unpredictable, and Belavadi had three additional months of pandemic usage data available to inform his analysis at the time Staff submitted his pre-filed testimony. It is reasonable for witnesses to debate the effect that anomalous usage data observed during the pandemic may have on future load growth, but mere differing views about inherently unpredictable and unprecedented events are hardly probative of intentional deception. Separately, WRA witness Brendan Baatz also made a baseless accusation that APS has "a poor record of load forecasting[,]" but failed to substantiate his claim or explain why it was relevant to his testimony. *See* Ex. WRA-1 (Baatz Direct) at 21 (Oct. 9, 2020). Crucially, though, neither witness accused APS of *intentionally manipulating* the Company's load forecast data to over-project load growth, much less for the purpose of maximizing the chances of its cost recovery as the Commission contends without basis in Decision No. 78317. Instead, the Commission simply asserts this conclusion as purported fact without any record citation nor identification of relevant evidence.

Moreover, nothing in the record in this case supports the Commission's allegation of "*intentional manipulation*." There is no evidence of scienter or intent to mislead;

indeed, there is not even any basis in the record for a finding that APS's load forecasts were unreasonable given the information available to APS at the relevant time and its obligation to ensure the reliability of its system in the face of inherently unpredictable demand. Nor is there any evidence demonstrating that APS intentionally or unintentionally withheld information from the Commission and/or the public regarding its forecasting methodologies, resource planning, or investment decisions. In addition, the allegation of intentional manipulation of load forecasting does not even logically correlate to APS's investment in the SCRs, because the Commission does not even attempt to suggest that any purported inaccuracy in APS's load forecasts was sufficiently substantial to bring into question the need for Four Corners' capacity to meet peak loads. As described in Staff witness Letzelter's Report, by 2017, Units 4 and 5 would produce a near-optimum annual reserve margin that would be necessary to maintain system integrity until at least 2023. Letzelter Report at 5 ("Over the subsequent seven years, the period of 2017-2023, the supply plan produces near-optimum annual reserve margins…While the first three years represent excess capacity, it diminishes at a reasonable rate (from a capacity planning and development perspective) through a fall in contracted resources and growth in APS load. The acquisition [of SCE's share] of Units 4 and 5 creates additional surplus capacity in the short term, but is necessary to maintain system integrity (as defined by reserve margin) in the long term."). And it is not surprising that the Commission does not attempt to provide any such explanation, because it could not possibly do so on this record. To the contrary, as the Commission was forced to admit, Four Corners (including the SCRs) was "used and useful during the TY and most notably during the heat storm in August 2020." Decision No. 78317 at 116:12-13. In fact, Four Corners was operating at virtually full capacity, and Arizona would likely have suffered rolling blackouts had it not been available to meet demand. *See* Ex. APS-8 (Albert Rebuttal) at 11. For all these reasons, the Commission's "finding" of "intentional manipulation" is not supported by substantial evidence and must be set aside.

The Commission's "finding" is also arbitrary and contrary to law. The Commission simply invented its theory of "intentional manipulation" out of whole cloth, without notice, without evidence, and without justification. APS had no opportunity to respond to any evidence of alleged misconduct against it, because no party offered any such evidence or advanced any such allegations. APS had no opportunity to cross-examine any witnesses against it on this issue, because there were no witnesses against it on this issue.

Fundamental principles of due process under the United States and Arizona Constitutions mandate that, even in an administrative proceeding, all those who are alleged to have violated some law, rule, or standard are entitled to notice of the allegations against them, an opportunity to be heard, and an opportunity to confront the witnesses against them. *See* U.S. Const. amend. XIV, § 1; Ariz. Const. art. 2 § 24; *Goldberg v. Kelly*, 397 U.S. 254, 269 (1970) ("In almost every setting where important decisions turn on questions of fact, due process requires an opportunity to confront and cross-examine adverse witnesses."); *Greene v. McElroy*, 360 U.S. 474, 496-97 (1959) (accused's right "to be confronted with the witnesses against him" extends to "all types of cases where administrative and regulatory actions were under scrutiny"). The Commission afforded none of these basic rights to APS. Its allegation of "intentional manipulation" must be set aside.

3. The Commission's Finding That APS Knew or Reasonably Should Have Known That Units 4 and 5 Were Not Cost-Effective Is Contrary to Law and Not Based on Substantial Evidence.

As part and parcel of its "finding" of "intentional manipulation," Decision No. 78317 also asserts (without citation of evidence) that "APS knew (or reasonably should have known) that Units 4 and 5 were no longer the most cost-effective resource option *before* the SCRs investments were made but either withheld that information or intentionally guided resource evaluations away from that possibility," and did so "to maximize its investments and minimize the risk of any disallowance." Decision No. 78317 at 113:9-13 (emphasis added). For all the reasons set forth in Section III.D.2 above, the purported finding of intentional manipulation cannot stand, and accordingly this intertwined assertion fails for the same reasons.

Even if examined in isolation, moreover, this purported finding is baseless. As explained in Section I.D.1.b, the record is devoid of evidence sufficient to support a finding of actual imprudence, and Decision No. 78317 does not even attempt to analyze the issues that would need to be addressed (and supported with clear and convincing evidence) in order to overcome the presumption of prudence and permit a finding that the information reasonably available to APS at a relevant point in time would have revealed that the only reasonable course was to shut down Four Corners, cancel the SCRs project, and obtain alternative sources of supply by 2018, and that doing so would have been less expensive than, while achieving the same necessary levels of reliability as, the course of action that APS actually chose.

For all of these reasons, this "finding" is contrary to law, is not supported by substantial evidence (let alone clear and convincing evidence), and should be set aside.

4. The Resource Planning Data Cited by the Commission as Purported Grounds for Disallowance of $215.5 Million of the SCRs Investment Provides No Support for That Decision.

The Decision points to several data points related to APS's resource planning as purported support for its disallowance of $215.5 million of the SCRs Investment, but that evidence provides no support for the Commission's decision.

First, The Commission states that "[i]n its 2012 IRP, APS determined, based on a low-gas-cost forecast, that it would save $497 million NPV from 2012-2041 if it did not acquire Units 4 and 5." Decision No. 78317 at 113:17-18. This datapoint serves only to confirm that APS did not withhold relevant analyses from the Commission. Instead, APS included a range of options and analyses, including this unlikely scenario of consistently low gas prices for the duration of the used and useful life of Four Corners, a scenario that APS reasonably believed had a low probability of occurring (and indeed has not occurred) due to the high volatility of natural gas prices. In the 2012 IRP, APS described its Low Cost Scenario and High Cost Scenario as "two distinct scenarios that incorporate the two *extremes of the cost spectrum*." APS 2012 Integrated Resource Plan at 51 (emphasis added). Thus, the scenario was expressly presented as a low probability, extreme case, not a realistic forecast of anticipated future events. It does nothing to establish imprudence, because the Commission makes no finding, and the record contains no evidence, that the only prudent course would have been for APS to assume that gas costs would necessarily remain low for the next 30 years and then make its investment decisions based on that highly speculative and improbable assumption (an assumption that the recent near-doubling of natural gas prices further reveals as unreasonable).

To the contrary, the Commission itself did not accept the notion that the low-gas-cost scenario reflected a realistic long-term assumption. In Decision No. 73130, the Commission approved the acquisition of Units 4 and 5, citing evidence that "a comparison of alternatives based upon the net present value of customer revenue requirements demonstrates that acquisition of SCE's share of Units 4 and 5 results in a revenue requirement that is $488 million lower than the alternative of replacing the retired Four Corners energy with natural gas generation[.]" Decision No. 73130 at 9.

The Commission's reliance on the 2012 IRP's low-cost-gas forecast as purported evidence of imprudence represents an unexplained change in its position from the determination it made in Decision No. 73130, in violation of the statutory procedures for changing a prior order under Ariz. Rev. Stat. § 40-252 ("The commission may at any time, upon notice to the corporation affected, and after opportunity to be heard as upon a complaint, rescind, alter or amend any order or decision made by it. When the order making such rescission, alteration or amendment is served upon the corporation affected, it is effective as an original order or decision. In all collateral actions or proceedings, the orders and decisions of the commission which have become final shall be conclusive."). For this reason as well, the 2012 IRP provides no support for disallowance of any portion of the SCRs Investment.

Second, the Commission states that "[a]lthough those low gas costs had become reality by APS's 2014 IRP, APS did not include a low-gas-cost forecast in its 2014 IRP and instead assumed that [Four Corners] would operate until 2038." Decision No. 78317 at 113:19-21. This assertion is incorrect. APS included two separate scenarios with low gas forecasts in its 2014 IRP. Both the "Gas Dominates Scenario" and the "Economic Contraction Scenario" included low-gas-cost forecasts (30% below the baseline). *See* APS 2014 Integrated Resource Plan at 58, 60. In the Gas Dominates Scenario, APS "assume[d] limited regulations on hydraulic fracturing and sustained low natural gas prices." *Id.* The Economic Contraction Scenario assumed "no additional shale gas regulation, which leads to low gas prices." *Id.*

Even leaving aside the inaccuracy of the Commission's assertion, it provides no basis for finding that a reasonable utility in 2014 would have projected that gas costs would remain low through 2038 or that a realistic forecast of gas prices as of 2014 would have caused a reasonable utility to decide to abandon its just-completed purchase of SCE's interest in Units 4 and 5 (which the Commission expressly determined to have been a prudent investment) in order to build or otherwise secure additional gas-fired supply (or that such an approach could have enabled APS to meet its reliability obligations in a more cost-effective manner than continued operation of Four Corners). At the time APS compiled its April 2014 IRP, it had already purchased SCE's share of Units 4 and 5 (with the Commission's approval), so it was no longer evaluating how to ensure adequate generation capacity in light of the impending SCE Transaction. Moreover, *after* submission of APS's 2014 IRP, the Commission found that the SCE Transaction was prudent because ongoing operation of Four Corners (necessarily entailing installation of SCRs) would be a more economic and reliable alternative than constructing new natural gas-fired generation to replace it, which would "expose APS's customers to the fuel price volatility that could result from over-reliance on natural gas as a fuel source." Decision No. 74876 at 19.

In the course of fully litigating Decision No. 74876, APS's natural gas forecasts were litigated among the parties and reviewed by the Commission to determine whether APS's acquisition of SCE's share of Units 4 and 5 in lieu of installing new natural gas-fired generation was prudent. The Commission concluded that it was, relying on extensive evidence to that effect and rejecting the Sierra Club's arguments that APS's natural gas price estimates were too high. Decision No. 74876 at 11-12, 17-18. The Commission specifically found that the acquisition would allow APS "to maintain a diverse resource portfolio *that does not overly expose APS's customers to the fuel price volatility that could result from over-reliance on natural gas as a fuel source*." *Id*. at 19 (emphasis added). Moreover, "[t]he transaction's direct benefits include[d] preservation of more stable rates and protection of the existing investment in Units 4 and 5, as opposed to new investment in gas-fired generation." *Id*. Having expressly rejected the notion that it was imprudent for APS to acquire SCE's share of and continue to operate Units 4 and 5 instead of obtaining gas-fired generation, the Commission is now foreclosed from contradicting that prior determination in this proceeding by implying that APS should have assumed that gas prices would remain low for the next three decades. Ariz. Rev. Stat. § 40-252.

Third, Decision No. 78317 states that "APS did not begin construction on the SCRs project until September 2015 and did not begin SCRs reactor installation until January 2017." Decision No. 78317 at 113:22-23. This statement provides no support for any assertion of alleged imprudence or intentional manipulation.

Fourth, Decision No. 78317 states that "[a]fter the SCRs project construction began, APS only analyzed a [Four Corners] retirement earlier than 2038 in its 2017 IRP (using a 2031 date) and concluded that APS's costs would be slightly increased in the 15-year term and slightly reduced over 30 years with the 2031 retirement." *Id*. at 114:1-3. This statement provides no support for a finding that the decision to invest in the SCRs project was imprudent. That investment decision was made years before 2017, so any inferences to be drawn from the 2017 IRP would be impermissible hindsight. Moreover, the 2017 IRP did not find any clear benefit to early retirement of Four Corners. It provided no basis whatsoever for a finding that continuing with the SCRs project was imprudent or that a more cost-effective approach would have been to shut down Four Corners and attempt to replace the lost generation capacity through other means by 2018. APS witness

Albert testified in this proceeding that the 2017 IRP results "indicated a slight increased cost in the 15-year term if Four Corners were retired in 2031 rather than 2038, and a slight savings in the long term (30 years)." Ex. APS-8 (Albert Rebuttal) at 12. Additionally, Mr. Albert testified that "[t]hese results did not provide a compelling economic reason to advance the [Four Corners] retirement date at that time." *Id*. Therefore, the 2017 IRP does not support a finding of imprudence.

Fifth, Decision No. 78317 provides that "[a]s of the close of record in this matter, APS had not analyzed the economic costs and benefits of continuing to operate [Four Corners] or the impact on retail rates of a pre-2031 retirement of either or both units of [Four Corners]." Decision No. 78317 at 114:4-6. This datapoint is legally irrelevant to the prudence inquiry, because it necessarily rests on hindsight, given that APS's decision to invest in the SCRs project was made long before "the close of record in this matter." Moreover, the fact that a specific analysis has not been done as of any given date does nothing to establish that if such an analysis had been done it would have provided clear and convincing evidence that installing the SCRs or operating Four Corners until 2031 would be imprudent.

Sixth, Decision No. 78317 provides that "[i]n its 2020 IRP, APS included [Four Corners] as a must-run resource in every scenario, with the same level of generation regardless of carbon costs or gas costs used." *Id*. at 114:7-8 As noted above, the Commission's reliance on the 2020 IRP is wholly improper hindsight analysis that has no place in a prudence inquiry. In any event, APS witness Albert testified that there are several reasons why APS did "not evaluate alternatives [to] retire Four Corners prior to 2031[,]" explaining that (1) "Four Corners is jointly owned by APS and four other entities, and together the owners have a coal contract that runs through 2031[;]" (2) "[i]t is not an option for APS to retire the plant without the agreement of the other owners[;]" and (3) "community impacts of retiring the plant are significant and must be carefully considered even before such evaluations could be made[.]" Ex. APS-8 (Albert Rebuttal) at 13. Neither Citizen Groups witness, Schlissel or Eisenfeld, sponsored testimony explaining how APS would be able to reliably manage its system if it were to retire Four Corners prior to 2031. Therefore, there is no evidence of APS planning imprudence on this basis.

E. The Disallowance of a Substantial Portion of APS's SCRs Investment Constitutes an Unlawful and Unconstitutional Penalty.

To the extent the Commission's decision to disallow $215.5 million of APS's SCRs Investment rests on purported "planning imprudence" in violation of a Commission-imposed duty and/or on allegedly "intentionally manipulating" load forecasts, the disallowance is also unlawful for the additional reason that it constitutes an impermissible penalty, without notice, in violation of the statutory and constitutional limits on the Commission's penalty authority. Under Arizona law, the Commission has no authority to impose such a penalty for violation of Commission requirements.

Pursuant to Ariz. Rev. Stat. § 40-424, if "any corporation or person fails to observe or comply with any order, rule, or requirement of the commission or any commissioner, the corporation or person shall be in contempt of the commission and shall, *after notice* and hearing before the commission, be fined by the commission in an amount *not less than one hundred nor more than five thousand dollars*, which shall be recovered as penalties." (emphasis added) The Arizona Constitution similarly constrains the Commission's authority to impose sanctions for violations of its requirements: "If any public service corporation shall violate any of the rules, regulations, orders, or decisions of the corporation commission, such corporation shall forfeit and pay to the state not less than one hundred dollars nor more than five thousand dollars for each such violation, to be recovered before any court of competent jurisdiction." Ariz. Const. art. 15, § 16.

There is little doubt that the Commission's disallowance decision is properly viewed as a penalty, to the extent it is predicated on purported intentional manipulation or APS's supposed breach of the new Commission-imposed duty to continually reexamine investment decisions. Indeed, the Sierra Club expressly recognized as much, arguing that "[t]he resulting $215.5 million disallowance is a meaningful penalty for the imprudence, and I urge you not to weaken that signal." *See* Tr. Vol. IV at 809 (Oct. 26, 2021).

Despite its statutory obligation to provide "notice" before imposing any penalty, the Commission did not provide APS with any notice that it allegedly violated a "duty" to engage in ongoing prudence reviews of each new expenditure for an ongoing project. Neither did APS have an opportunity to present evidence to defend itself against any such allegation. Nor did APS have any notice or an opportunity to defend itself against the belated and baseless claim of intentional manipulation. These flaws compel reconsideration of the disallowance decision.

Additionally, and more fundamentally, the \$215.5 million disallowance penalty imposed by the Commission vastly exceeds its penalty authority, which both the Constitution and the governing statute make clear is limited to \$5,000 per violation. For these reasons, the Commission's disallowance of \$215.5 million of the SCRs Investment must be set aside.

F. The Commission Is Estopped from Breaching the Regulatory Compact by Failing to Recognize the Prudence of the SCRs Investment.

The regulatory compact between a State and the utilities providing service provides the fundamental basis for utility regulation. The State grants the utility "a monopoly in a geographical area for the provision of a particular good or service." *PacifiCorp v. Pub. Serv. Comm'n of Wyo.*, 2004 Wy. 164, ¶ 28, 103 P.3d 862, 871 (Wyo. 2004). In exchange, "the utility is subject to regulation by the state to ensure that it is prudently investing its revenues in order to provide the best and most efficient service possible to the consumer [and] the utility is allowed to earn a fair rate of return on its rate base." *Id.* "It is elementary that a public utility subject to regulation and fixing of rates is entitled to realize a fair and reasonable profit from its operation in the service of the public." *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 149 (1956). The regulatory compact includes the guarantee that a rate will "be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." *Litchfield Park Serv. Co. v. Ariz. Corp. Comm'n*, 178 Ariz. 431, 434 (App. 1994) (quoting *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 689 (1923)).

The Commission's prior decisions establish the necessity and thus the prudence of the decision to install the SCRs. By approving the SCE Transaction (specifically including the need to install EPA-mandated emissions technology, i.e., the SCRs) and deeming that acquisition to be prudent and in the best interests of customers, the Commission necessarily endorsed the propriety of installing SCRs, which were necessary to permit the continued operation of Units 4 and 5. APS reasonably relied on the Commission's prior decisions in proceeding with the SCRs Investment, and accordingly the Commission is estopped from denying it recovery of its reasonable expenditures in achieving that already-approved result.

By backtracking on the Commission's prior decisions recognizing the prudence of APS's decision to acquire and operate Units 4 and 5 and install the SCRs, the Decision violates the fundamental premises of the regulatory compact. Denying APS the right to recover investments that were essential to achieve the very benefits endorsed by the Commission in approving the transaction is not consistent with the Commission's fundamental agreement to fairly ensure "sufficient revenue to meet the cost of furnishing service and to earn a reasonable profit." *Ind. Off. of Util. Consumer Counselor v. Duke Energy Ind., LLC*, 169 N.E.3d 417, 424 (Ind. Ct. App. 2021) (citations and quotations omitted). Nor is it the result of a fair consideration of "all relevant facts," which in this case include the Commission's past approvals that led to APS's purchase of Units 4 and 5 and resulting investment in the SCRs.

The Commission is therefore estopped from denying APS cost recovery of $215.5 million of its SCRs Investment. "Equitable estoppel is a rule of justice which, in its proper field, prevails over all other rules." *United States v. Georgia-Pacific Co.*, 421 F.2d 92, 96 (9th Cir. 1970). Traditionally, estoppel could not be invoked against the State. *See Freightways, Inc. v. Ariz. Corp. Comm'n*, 129 Ariz. 245, 247 (1981) ("*Freightways*"). However, "[e]xceptions have been made[.]" *Id.* (citing *United States v. Stinson*, 125 F. 907, 910 (7th Cir. 1903), aff'd 197 U.S. 200 (1905)). In particular, the Arizona Supreme Court has adopted the *Lazy FC Ranch* test to determine when it is appropriate to apply estoppel to the State. *See Freightways*, 129 Ariz. at 248. In *United States v. Lazy FC Ranch*, 481 F.2d 985, 989 (9th Cir. 1973), the Ninth Circuit held that the State can be estopped if the government's wrongful conduct threatens to work a serious injustice and if the public interest would not be unduly damaged by the imposition of estoppel.

In *Freightways*, the Arizona Supreme Court found that the Commission was estopped from denying the validity of a certificate of public convenience and necessity it had previously granted to Freightways' predecessor. The Court explained that: (1) the Commission knew of the defects in the certificate; (2) the Commission expected the certificate to be used by Freightways and its successors in interest and recognized by the public; (3) Freightways lacked knowledge of any defect in the certificate, relied upon the certificate, and would be prejudiced by cancellation of the certificate; and (4) upholding validity of the certificate would not be a threat to the sovereignty of the Commission. *See Freightways*, 129 Ariz. at 247–48.

Similarly, in a tax dispute regarding TEP's payment of Arizona income tax based on accelerated depreciation on emissions control devices installed at the Four Corners and San Juan electric generating facilities, the Court of Appeals found that the State was estopped from denying the sufficiency of TEP's compliance with certification requirements of a former statute based on the Department of Revenue supervisor's representation. *Tucson Elec. Power Co. v. Ariz. Dept. of Revenue*, 174 Ariz. 507, 517 (App. 1992) ("*Tucson*").

Arizona courts have thus applied two distinct sets of elements to determine whether estoppel is appropriate in this context. *Freightways* applied elements recognized by the Ninth Circuit in *Hampton v. Paramount Pictures Corp.*, 279 F.2d 100, 104 (9th Cir. 1960), cert. denied 364 U.S. 882 (1960) ("*Hampton*"):

(i) The party to be estopped must know the facts;

(ii) He must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended;

(iii) The latter must be ignorant of the true facts; and

(iv) He must rely on the former's conduct to his injury.

Tucson applied the *Hampton* elements but also examined the facts using the elements of equitable estoppel grounded in Arizona law. Those include: "(1) affirmative acts inconsistent with a claim afterwards relied upon; (2) action by a party relying on such conduct; and (3) injury to the party resulting from a repudiation of such conduct." *Tucson* 174 Ariz. at 516 (citing *Decker v. Hendricks*, 97 Ariz. 36, 40 (1964)) ("*Decker* test").

In this case, the Commission is estopped from denying APS full recovery of and on its SCRs Investment under either of the tests applied by the Arizona courts. Each of the elements of the *Hampton* test applied in *Freightways* is satisfied here.

First, the Commission was well aware of the relevant facts: APS informed the Commission that any decision to purchase Units 4 and 5 of Four Corners for their intended purpose would necessarily entail a substantial investment in the SCRs in order for the units to continue operating. *See* Decision No. 73130 at 7. This presentation of evidence to the Commission began in 2010. The Commission had voluminous records before it that demonstrated the need, legal requirements, and economic and reliability benefits that support APS's long-term operation of Units 4 and 5 and thus its installation of the SCRs to make that possible (i.e., as BART, pursuant to federal environmental regulatory requirements). *See id*. at 20.

Second, the Commission approved APS's acquisition of SCE's interest in Four Corners Units 4 and 5 with the full expectation that APS would act in accordance with that approval. In subsequently finding APS's acquisition to be prudent, the Commission knew that this investment necessarily required APS to proceed with installing the SCRs on Units 4 and 5 (i.e., as the pollution controls EPA determined to be BART for the Plant). Executing the SCE Transaction and the installation of the SCRs were essential and interrelated steps necessary for APS and its customers to be able to obtain the anticipated future benefits that were an important factor in the Commission's decision, namely, the benefits to be derived from ongoing operation of Four Corners. Decision No. 74876 at 10. Specifically, in the 2012 Commission decision authorizing the SCE Transaction, the

Commission acknowledged that "[a]s part of its requested authorization to acquire … Units 4 and 5," APS "plans to add pollution control equipment to Units 4 and 5 by 2018." Decision No. 73130 at 7; *see also id*. at 11 (noting APS's testimony that "if the transaction is completed … emission controls will be installed on Units 4 and 5"). The Commission explicitly found that "acquiring an interest in the more efficient plants [i.e., Units 4 and 5] and *installing environmental upgrades would provide 'unique value' to [APS's] customers*, both from an environmental and rate impact standpoint." *Id*. at 32 (emphasis added). The Commission also recognized and affirmed "the value of maintaining a diverse energy supply portfolio that balances coal, gas, and nuclear generation to complement the growing role of renewable resources," and APS's "need to maintain a diverse resource portfolio" and "maintain the balance of coal resources in its resource portfolio." *Id*. at 31-32. Accordingly, Decision No. 73130 authorized APS to move forward with the "proposed transaction," which it expressly defined to include both the purchase of Units 4 and 5 and the installation of BART. *Id*. at 7.

Similarly, in Decision No. 74876, the Commission found the very same transaction prudent. *See* Decision No. 74876 at 43 ("The transaction by which APS acquired SCE's share of Units 4 and 5 was prudent, and the rate recovery pursuant to the terms of the Settlement Agreement adopted by Decision No. 73183 is appropriate. The acquisition will help ensure the continued provision of reliable and reasonably priced electricity for APS's customers."). These decisions reflect the fact that, even taking into account the anticipated costs of installing the SCRs as a necessary and integral component of the purchase decision, APS had demonstrated that the best option would be to close Four Corners Units 1-3 to avoid the need to install additional emissions-control technology on those smaller units and to acquire SCE's interest in Units 4 and 5, thereby striking a reasonable cost and benefit balance to maintain system reliability and protect customers. *See* Decision No. 73130 at 10. Based on this evidence, the Commission knew that if it authorized APS to acquire SCE's interest in Units 4 and 5 and allowed those costs to be recovered in APS's retail electricity rates, APS would be required and would intend to, no later than 2018, install SCRs (as the required BART) at Four Corners to continue the lawful generation of electric power at the facility. Accordingly, the Commission's decisions gave APS ample reason to believe that it could rely on those determinations as a firm foundation on which to proceed with the SCR installation and reasonably anticipate that it would be permitted to recover its SCRs Investment.

Third, until the Recommended Opinion and Order issued in this case on August 2, 2021, and the Commission adopted the amendment from Commissioners O'Connor and Tovar disallowing $215.5 million of APS's SCRs Investment, APS had no reason to believe that the Commission would refuse to adhere to its previous approval of the purchase (including the anticipated installation of the SCRs) and its determination that the SCE Transaction was prudent.

Fourth, APS relied on the Commission's decisions by closing on the acquisition (thereby committing itself to close Units 1-3 and install SCRs on Units 4 and 5). Similarly, APS relied on the Commission's finding that the acquisition was prudently incurred to execute the consent decree with the EPA, execute an engineering, procurement and construction agreement to begin substantial capital investment to install the SCRs, and expend hundreds of millions of dollars to install SCRs. APS similarly relied on the Commission's grant of the SCR Deferral in its order on the 2016 rate case. Decision No. 78317's denial of APS's request to recover a substantial portion of the SCRs Investment frustrates APS's reasonable investment-backed reliance interests and injures APS and its shareholders.

The Commission is similarly estopped from denying APS recovery of the full value of its SCRs Investment based on the *Decker* test. First, Decision No. 78317's final order denying APS recovery of a substantial portion of the SCRs Investment is an affirmative act that is inconsistent with the Commission's prior decisions on which APS relied, for the same reasons discussed above. Second, APS took action in reasonable reliance on the Commission's prior orders, as evidenced by the fact that it proceeded to purchase SCE's share of Units 4 and 5, thereby assuming the obligation to install the SCRs in order to keep those units operating, and ultimately expended hundreds of millions of dollars to install SCRs in compliance with that obligation, just as it had assured the Commission it would do if the Commission approved the purchase. Third, APS has suffered harm because of the disallowance of a substantial portion of its SCRs Investment. Indeed, APS has already suffered immediate harm as credit ratings agencies have downgraded the Company, thus affecting its ability to borrow debt and attract capital at reasonable terms.

For all the foregoing reasons, the Commission is estopped from breaching the regulatory compact by denying APS recovery for its reasonable decision to proceed with the SCRs Investment in reliance on the Commission's prior decisions establishing the necessity and thus the prudence of that decision. The Commission should reconsider its unjust and unlawful decision to deny APS full recovery of and on its used and useful investment in maintaining the reliability of Arizona's electric power system.

G. Decision No. 78317 Violates the Fifth and Fourteenth Amendments to the U.S. Constitution and Section 17 of Article 2 of the Arizona Constitution by Taking a Substantial Portion of APS's Used and Useful Utility Property Without Providing Just Compensation.

By examining the SCRs Investment on a single-issue basis and preventing APS from recovering a substantial portion of the full value of its SCRs Investment, the Commission has violated the Fifth and Fourteenth Amendments to the U.S. Constitution and Section 17 of Article 2 of the Arizona Constitution by taking a substantial portion of APS's SCR utility property without just compensation. The Fifth Amendment of the U.S. Constitution provides, "nor shall private property be taken for public use, without just compensation." And as is relevant here, the U.S. Supreme Court has consistently held that state authority to regulate public utility rates does not extend to ratemaking decisions that impose a "deprivation of property without due process of law or the taking of private property for public use without just compensation." *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 51 (1936).

Similarly, Article 2, Section 17, of the Arizona Constitution provides that "[n]o private property shall be taken or damaged for public or private use without just compensation having first been made." Accordingly, this Article would be violated because the Arizona Supreme Court has held that the Commission may not require the utility to "add improvements to its utility property for which no compensation could be received." *Ariz. Corp. Comm'n v. Tucson Gas, Elec. Light & Power Co.*, 67 Ariz. 12, 18 (1948). By authorizing acquisition of SCE's interest in Units 4 and 5 and deeming the acquisition thereof and APS's future plan of operation of the units prudent, APS was effectively required to "add improvements to its utility property," *id.*, namely, the SCRs. As a result, the Commission is barred from denying APS compensation in the form of cost recovery on the SCRs Investment.

Similarly instructive is the D.C. Circuit's treatment of certain orders arising from litigation at the Federal Energy Regulatory Commission ("FERC") whereby the court held that FERC's rulings preventing public utilities from recovering a rate of return on upgrades added to their electric system to accommodate customer interconnections would violate *Hope* and *Bluefield* and that the agency would need to better explain its determinations. *Ameren Serv. Co. v. FERC*, 880 F.3d 571, 581 (D.C. Cir. 2018) ("*Ameren*") ("Investors, however, invest in entire enterprises, not just portions thereof. FERC must explain how investors could be expected to underwrite the prospect of potentially large non-profit appendages with no compensatory incremental return."). The court determined that FERC could not require a utility to maintain portions of its electric system on a non-profit basis and these upgrades for which it could not earn on were impermissible non-profit appendages, which violated the U.S. Constitution. *Id*. at 581.

In the instant case, the Commission has denied APS cost recovery of $215.5 million of its SCRs Investment, making approximately half of the SCRs not only non-profit, but subject to operation at a loss to APS. The D.C. Circuit's opinion in *Ameren* demonstrates that costs incurred for used and useful utility property must be recovered as investors contribute capital to the entire enterprise of the public utility. *Id*. ("[B]y modifying the transmission owners' entire enterprise, FERC's orders attack their very business model and thereby create a risk that new capital investment will be deterred."). If more and more of APS's electric system are required to be operated at a loss or a non-profit basis, Arizona's regulatory climate "would likely deter investors and diminish the ability" of APS "to attract capital for future maintenance and expansion" of the grid of the future that is needed for Arizona to achieve continued and sustainable economic growth. *Ameren*, 880 F.3d at 582.[19]

Accordingly, the Commission should reconsider its decision to deny APS just compensation for its reasonable investment in the SCRs, which have been dedicated to public service in Arizona for the benefit of Arizona electric customers, and without which, the reliability of the Arizona electric power system would be in serious doubt.

III. DECISION NO. 78317 ARBITRARILY, CAPRICIOUSLY, WITHOUT SUBSTANTIAL EVIDENCE, AND CONTRARY TO LAW DENIES APS AN APPROPRIATE ROE.

In Decision No. 78317, the Commission establishes APS's revenue requirement based on a ROE of 8.7%. Decision No. 78317 at 323:18. If this ROE is upheld, it would put APS's ROE as one of the lowest equity returns in the Nation among electric utilities. More particularly, the Commission establishes a base ROE of 8.9%, but then reduces it by 20 b.p. as a penalty for what the Commission considers to be inadequate customer service by the Company, yielding an "all-in" ROE of 8.7%. *Id.* at 323:17-20. This ROE is arbitrary, unlawful, and unsupported by substantial evidence. Instead, the ACC should establish an all-in ROE for APS of at least 9.47%, a figure that is consistent with the minimum applicable legal precedent and supported by substantial evidence.

A. APS's ROE Must Be Set in Accordance with *Hope* and *Bluefield.*

The U.S. Supreme Court's decisions in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), and *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923), establish

[19] The Commission seems to misunderstand APS's intent and lambasted the Company and its shareholders for offering to recover the SCRs Investment at the embedded cost of debt in lieu of an equity return, which its shareholders are truly due: "My concern, Madam Chairman, is that we have a company who today I think is greedier than greed. And to send us, in black and white, a proposed amendment that just – you know, it's only in their favor and their shareholders' favor…" Open Meeting Transcript Vol. IV at 820 (Oct. 26, 2021).

the legal standards to which a regulatory commission must adhere when setting a regulated ROE such as the ROE here.

Hope holds that a utility's ROE "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital," and "be commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603 (citing *State of Mo. ex rel. Sw. Bell Tel. Co. v. Pub. Service Comm'n of Mo.*, 262 U.S. 276, 291 (1923) (Brandeis, J., concurring)). *Bluefield* similarly holds that "[a] public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties." *Bluefield*, 262 U.S. at 692.

The Commission has repeatedly pointed to *Hope* and *Bluefield* in support of these ratemaking principles. *See, e.g.*, Decision No. 77850 (Dec. 17, 2020) at 70, Ariz. Corp. Comm'n Docket No. G-01551A-19-0055 (*In the Matter of the Appl. of Sw. Gas Corp.*) (quoting and relying on *Hope* and *Bluefield* and stating "[t]he *Bluefield* and *Hope* decisions provide that the Commission must determine a return that is equivalent to an investment with similar risk made at generally the same time, and should be sufficient under efficient management to enable the utility to discharge its duties"); Decision No. 77269 (June 27, 2019) at 14, Ariz. Corp. Comm'n Docket No. W-01654A-18-0083 (*In re Farmers Water Co.*) (*Hope* and *Bluefield* "provide that the Commission must determine a return that is equivalent to an investment with similar risk made at generally the same time"); Decision No. 73996 (July 30, 2013) at 39, Ariz. Corp. Comm'n Docket No. WS-02676A-12-0196 (*In re Rio Rico Utilities, Inc.*) (same); Decision No. 73736 (Feb. 20, 2013) at 42-43, Ariz. Corp. Comm'n Docket No. W-01445A-11-0310 (*In re Arizona Water Co.*) (*Hope* and other cases "provide that the return determined by the Commission must be equal to an investment with similar risks made at generally the same time") (internal quotations omitted); Decision No. 69664 (June 28, 2007) at 29, Ariz. Corp.

Comm'n Docket No. SW-02519A-06-0015 (*In Re Gold Canyon Sewer Co.*) (same). *See also Sun City Water Co. v. Ariz. Corp. Comm'n*, 26 Ariz. App. 304, 309 (App.), *vacated on other grounds by* 113 Ariz. 464 (1976) (quoting and relying on *Bluefield*); *Lone Star Gas Co. v. Corp. Comm'n of State of Okla.*, 648 P.2d 36, 39 (Okla. 1982) (citing *Hope* and *Bluefield* for the proposition that "[a] public utility is entitled to earn a return on the value of the property which it employs for the convenience of the public and a return to the equity owner sufficient to enable the public utility to operate successfully, maintain its financial integrity, attract capital, and compensate its investors for the risk assumed").

And, further, Decision No. 78317 itself acknowledges the controlling force of *Hope* and *Bluefield*, stating that these "seminal U.S. Supreme Court cases . . . have established that the authorized return on equity ('ROE') for a public utility must be sufficient to maintain the utility's financial integrity, enable the utility to attract capital under reasonable terms, and be commensurate with returns that investors could earn by investing in other enterprises of comparable risk." Decision No. 78317 at 304:19-25.

The Commission was legally bound to follow these precedents in setting an ROE for APS in the present proceeding. As discussed *infra*, however, Decision No. 78317 fails to do so.

B. It Is Unlawful for the ACC to Reduce APS's ROE as a Penalty for Alleged Customer Service Issues.

In an unprecedented move, Decision No. 78317 reduces APS's ROE by 20 b.p. for what the Commission alleges to be "deficiencies in APS's customer service performance . . . ." Decision No. 78317 at 323:20-21. This decision is arbitrary and unlawful for a variety of reasons.

First, this action by the Commission is a clear violation of *Hope* and *Bluefield* and related Arizona cases recognizing and adopting those holdings insofar as it results in an ROE that is not on par with—and is lower than—the returns earned by entities with corresponding risks. *Bluefield* states clearly that a regulated ROE must be *"equal"* to the rate earned on investments with similar risk. 262 U.S. at 692 (emphasis added). In

Decision No. 78317, the Commission determined that such rate was 8.9%. Decision No. 78317 at 323:19. That rate is impermissibly low, as APS shows in Section III.C, below. But even if 8.9% were the correct rate, and it is not, that would demonstrate the unlawful nature of the additional 20 b.p. reduction mandated by the Decision, which necessarily reduces the rate below the level required by *Bluefield*. Anything less is *per se* not "equal" to the rate on investments with similar risk. Accordingly, any downward adjustment to the base ROE based on something other than the return on similar investments violates *Bluefield* and Commission precedent.

Second, by reducing the Company's ROE by 20 b.p., the Commission has exceeded the proper scope of its inquiry for setting an ROE for APS by basing its ROE determination on non-economic/risk factors. *Stewart v. Utah Pub. Serv. Comm'n*, 885 P.2d 759, 768 (Ut. 1994) ("In both rate-of-return and rate-base cases, the issue is what *economic* factors the Commission may consider in determining what rates should be charged ratepayers for the benefit of shareholders . . . .") (emphasis added). *See also Sun City Water Co.*, 26 Ariz. App. at 309 ("The cost of equity capital is not capable of such ma[]thematical precision and in fact is a judgment call, enlightened by consideration of all the relevant factors. However, for the purposes of this preliminary discussion, *cost of equity capital is normally determined by two methods—the 'investor method', that is, an analysis of how investors form reasonable expectations of the earning-dividend and growth expectation of utility stocks or the 'opportunity cost comparative earnings method', that is, what capital would earn in other enterprises of corresponding risks and hazards*.") (emphasis added).

At least three courts have found to be unlawful actions by regulatory agencies similar to those undertaken by the Commission here. For example, the Florida Supreme Court squarely rejected as impermissible the approach followed by the Commission here: "The respondent-Commission had no authority to deny an increase in rates which it found to be just, by the means of inflicting a penalty because of poor or inadequate service, and exceeded its jurisdiction when it inflicted such penalty in a rate-making proceeding." *Fla.*

Tel. Corp. v. Carter, 70 So.2d 508, 510 (Fla. 1954) (en banc). The Kentucky Supreme Court has recognized precisely the same principle: "We believe that granting the Commission the authority, in a rate case, to penalize the utility for poor service would be an improper extension of the statutory procedure. The rate making process is to provide for the utility a reasonable profit on its operations so that its owners may achieve a return on their investment. Such matters are purely those of a financial nature." *S. Cent. Bell Tel. Co. v. Util. Regulatory Comm'n*, 637 S.W.2d 649, 653 (Ky. 1982). *Accord Elyria Tel. Co. v. Pub. Utils. Comm'n*, 110 N.E.2d 59, 63 (Ohio 1953) ("Upon the record in this case, the commission erred in suspending the increased rates until such time as the services and facilities have been improved.").[20] The outcome here should be no different and the Commission should reverse its ruling accordingly.

Third, the Commission's decision to reduce APS's ROE by 20 b.p. based on alleged customer service performance issues is unsupported by substantial evidence. The only purported support in the record for this reduction is the prefiled, direct testimony of RUCO witness Jordy Fuentes. *See generally* Ex. RUCO-6 (Fuentes Direct). But Mr. Fuentes provided no quantitative analysis whatsoever to justify this 20 b.p. reduction. Rather, he recited a litany of *alleged* issues with APS's customer service, and then simply asserted that "RUCO recommends the Commission adopt a 20 basis point reduction to the Company's ROE." *Id.* at 11:23-25. APS, however, thoroughly rebutted these allegations—a fact that the Commission entirely ignores in reaching its decision to reduce the ROE by 20 b.p. *See* Decision No. 78317 at 63:4-64:10.

Basing a ruling on RUCO's unfounded allegations and speculation is the epitome of arbitrary and capricious decision making—a quantitative finding based not on any

[20] It also bears noting that, in jurisdictions where the utility commission has permitted a reduction in ROE based on customer service issues, the applicable law expressly identified management efficiency or the like as a factor that the commission may or must consider in setting rates. *See* 35-A.M.R.S.A. § 301 (Maine law explicitly calling out "efficient[]" operations and "sound management practices" as a basis for setting rates); Order No. 23573 (Oct. 3, 1990, Fla. P.S.C. Docket No. 891345-EI (*Re Gulf Power Co.*) (caselaw and statute "grant this Commission ample authority to take management efficiency into account in setting rates"). Arizona law contains no such provision and the practices in these other states are wholly inapposite.

quantitative analysis but, rather, an arbitrary and unsupported number. *Compassionate Care Dispensary, Inc. v. Ariz. Dep't of Health Servs.*, 244 Ariz. 205, 213 (App. 2018) (quoting *Motor Vehicle Mfrs. Ass'n of U.S. v. State Farm Mut. Auto. Ins.*, 463 U.S. 29, 43 (1983)) ("An agency acts arbitrarily and capriciously when it does not examine 'the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made."'"); *Turner Ranches & Sanitation Co. v. Ariz. Corp. Comm'n*, 195 Ariz. 574, 577-78 (App. 1999) ("This record contains no support for an overall rate of return of 5.5 percent. . . . Accordingly, this case is remanded to the Commission to establish a rate schedule that will produce an appropriate overall rate of return."). *See also Sorenson Communications Inc. v. FCC*, 755 F.3d. 702, 709 (D.C. Cir. 2014) (citing *Motor Vehicle Mfrs. Ass'n of U.S.*, 463 U.S. at 43) (holding that a price floor of $75 was arbitrary and capricious because the agency could not adequately explain why it chose $75).

Fourth, the Commission's reliance on Mr. Fuentes's testimony as the basis for penalizing APS is a violation of due process because he was unavailable for cross-examination. Although Ms. Woodall adopted Mr. Fuentes's testimony, she made clear that she was not offering her own opinion but was merely urging the Commission to rely on Mr. Fuentes's testimony directly and, on that basis, avoided answering substantive questions regarding Mr. Fuentes's testimony. *See, e.g.*, Tr. Vol. XIX at 4067:19-22 (Feb. 18, 2021) (Ms. Woodall stating, "my role here was to adopt [Mr. Fuentes's] testimony, not to assert particular positions of RUCO as a . . . government agency"); Tr. Vol. XXI at 4537:12-18 (Feb. 22, 2021) ("Q. Okay. Can you speak at all to why RUCO chose a 20 basis point adjustment rather than some other figure, such as a 10 basis point reduction or a 50 basis point reduction? A. I did not know what Mr. Fuentes had in his mind when he identified this number. So the answer to your question is no."); *id.* at 4536:9-14 ("I don't know what was in Director Fuentes' mind when he wrote this testimony, and so I don't know what he meant to imply. I only have the printed words on the page . . . and I am reluctant to speculate.").

The Supreme Court has stated that "[i]n almost every setting where important decisions turn on questions of fact, due process requires an opportunity to confront and cross-examine adverse witnesses." *Goldberg v. Kelly*, 397 U.S. 254, 269 (1970). *See also Greene v. McElroy*, 360 U.S. 474, 496-97 (1959) (the accused's right "to be confronted with the witnesses against him" extends to "all types of cases where administrative and regulatory actions were under scrutiny" (internal quotations omitted)). But APS did not have that opportunity here, as a result of Mr. Fuentes's unavailability and Ms. Woodall's avoidance of answering substantive questions, as noted above. Due process therefore precludes the Commission's reliance on Mr. Fuentes's testimony as the basis for its 20 b.p. reduction in APS's ROE.

Fifth, the 20 b.p. reduction in APS's ROE is unlawful because it constitutes a penalty imposed by the Commission far exceeding its constitutional and statutory authority, which limits penalties to $5,000 per violation. Ariz. Const. art. 15, § 16 ("If any public service corporation shall violate any of the rules, regulations, orders, or decisions of the corporation commission, such corporation shall forfeit and pay to the state not . . . more than five thousand dollars for each such violation, to be recovered before any court of competent jurisdiction."); Ariz. Rev. Stat. § 40-424 ("If any corporation or person fails to observe or comply with any order, rule, or requirement of the commission or any commissioner, the corporation or person shall be in contempt of the commission and shall, after notice and hearing before the commission, be fined by the commission in an amount not . . . more than five thousand dollars, which shall be recovered as penalties."). The 20 b.p. ROE reduction amounts to approximately $28.4 million per year in reduced revenue[21] for APS—far in excess of the $5,000 penalty limitation. The 20 b.p. reduction thus violates both the Arizona Constitution and Arizona statutory law and must be eliminated.

Sixth, the 20 b.p. reduction is also unlawful insofar as the Commission provided no prior notice to APS that it was considering imposing a penalty on the Company for

[21] *See* APS Response to Commissioner Olson in Docket No. E-01345A-19-0236 (Sept. 17, 2021).

allegedly poor customer service. Ariz. Rev. Stat. § 40–424 is clear that a penalty may be imposed only "after notice," but no such notice was provided to APS at any time in the form of an order to show cause, contempt hearing, or otherwise. The 20 b.p. reduction of ROE is thus unlawful.

C. Both a Base ROE for APS of 8.9% and an All-In ROE of 8.7% Are Unjust, Unreasonable, Arbitrary, and Unlawful.

Despite the clear precedents of *Hope* and *Bluefield*, the Commission in Decision No. 78317 establishes a base ROE for APS of 8.9% and an all-in ROE of 8.7% that are unjust, unreasonable, arbitrary, and unlawful. *See* Decision No. 78317 at 323:18. That decision must be reversed and the all-in ROE of 8.7% must be replaced with a higher rate that is consistent with applicable legal standards and precedent. *See, supra*, *Sun City Home Owners Ass'n*, 496 P.3d at 425 and *Freeport Minerals Corp.*, 244 Ariz. at 411.

1. The Base ROE of 8.9% Established by Decision No. 78317 Is Based on Faulty Quantitative Analyses.

The 8.9% base ROE established by Decision No. 78317 is based on the faulty analyses of RUCO's witness John Cassidy. Like witnesses for Commission Staff, APS, and FEA, Mr. Cassidy submitted the results of a variety of commonly-used quantitative analyses to estimate ROE of other utilities. Decision No. 78317 at 315:6-318:11. These analyses included a discounted cash flow ("DCF") analysis, a capital asset pricing model ("CAPM") analysis, a comparable earnings analysis, risk premium analysis, and an expected earnings analysis. Decision No. 78317 at 304:16-323:15. Indeed, all four witnesses that submitted quantitative analyses in support of a requested ROE conducted and reported the results of a CAPM analysis. Decision No. 78317 at 306:13-307:7 (APS), 314:1-5 (FEA), 316:10-14 (RUCO), 320:20-26 (Staff). But Mr. Cassidy's approach to his CAPM analysis and his reliance on it stands in marked contrast to the analyses provided by all other participants.

First, for his CAPM analysis, Mr. Cassidy relied on fully historical data dating back to 1978. Ex. RUCO-4 (Cassidy Direct) at 48:17-52:19. But it is a fundamental requirement of *Bluefield* that the established ROE be commensurate with the return on equivalent investments "generally being made *at the same time* . . . ." *Bluefield*, 262 U.S. at 692 (emphasis added). The Commission therefore erred in relying on Mr. Cassidy's legally flawed analysis, which impermissibly relied fully on historical data to determine an appropriate return on investments being made in the present. Instead, the Commission should have relied upon a CAPM analysis that is based at least in part on forward-looking data, such as that conducted by APS witness Ann Bulkley, as discussed in Section III.C.4, below. *Cf. State of Mo. ex rel. Sw. Bell Tel. Co.*, 262 U.S. at 287-88 ("It is impossible to ascertain what will amount to a fair return upon properties devoted to public service, without giving consideration to the cost of labor, supplies, etc., at the time the investigation is made. An honest and intelligent forecast of probable future values, made upon a view of all the relevant circumstances, is essential."); *Simms v. Round Valley Light & Pwr. Co.*, 80 Ariz. 145, 151 (1956) (citing *State of Mo. ex rel. Sw. Bell Tel. Co.*, 262 U.S. 276) ("Fair value means the value of properties at the time of inquiry").

Notably, Mr. Cassidy's use of aged data has a material impact on his results. For example, to establish the risk premium that is used as an input into the CAPM calculations, Mr. Cassidy uses data that spans 1978 to 2019. *See* Ex. RUCO-4 (Cassidy Direct) at 52:6-19 & Sched. JAC-4 at 2. But the average risk premium from the first half of Mr. Cassidy's data (1978-1998) is 5.54%, whereas for the latter half (1999 to 2019) is 9.25%. Mr. Cassidy's use of such old, pre-1999 data, therefore greatly skews his results and there is no reasonable basis to use decades-old data to estimate future returns other than to force down the average. *Potomac Elec. Power Co. v. Pub. Serv. Comm'n*, 380 A.2d 126, 134 (D.C. Ct. App. 1977), *aff'd en banc*, 402 A.2d 14 (1979) (citing *West Ohio Gas Co. v. Pub. Utils. Comm'n*, 294 U.S. 79, 82 (1935)) ("It is well settled that the rate maker may not rely on out-of-date information when more recent actual experience, which shows a substantial disparity between the earlier forecasts and the rate of return actually earned, is available.")

Second, the results of Mr. Cassidy's stale and backward-looking CAPM analysis are questionable on their face as they are wildly out of line with the results of his other

ROE analyses. Mr. Cassidy's CAPM analysis yields a midpoint value of 7.75%. Decision No. 78317 at 316:14. This is almost one percentage point lower than the midpoint value of his DCF analysis (of 8.63%) and two full percentage points lower than the midpoint value of his compable earnings analysis (9.75%). *Id.* at 316:10, 316:19. This fact alone should have clued in the Commmission to the fact that Mr. Cassidy's CAPM analysis was an unreliable outlier and not probative for purposes of setting APS's ROE.

Commission Staff, for its part, also conducted a backward-looking CAPM analysis, which yielded a median result of 6.4%. Decision No. 78317 at 320:22. But Staff correctly recognzied the fact that this value was an outlier as compared to its DCF, comparable earnings, and risk premium results (of 9.2%, 9.5%, and 8.7%, respectively), *id.* at 320:15.5, 321:8, 321:21.5, and thus rightfully chose not to include the results of its CAPM analysis in establishing its recommended ROE of 9.4%, *id.* at 322:7-10. And FEA, the only other participant to submit quantitative ROE analyses, relied on a CAPM result of 9.6%, based on a combination of backward- and forward-looking risk premium data. *Id.* at 314:1-5.

Indeed, the backward-looking CAPM results (both those of Mr. Cassidy and Commission Staff) are grossly out of line with the results of their other analyses (i.e., their DCF, comparable earnings, and risk premium analyses) and thus should have been disregarded, as Commission Staff did. It is thus arbitrary and capricious for the Commission to establish an ROE for APS that is based in any way on this faulty and anomalous backward-looking CAPM analysis conducted by Mr. Cassidy for RUCO.

2. An 8.9% Base ROE Unlawfully Violates the Capital Attraction Standards of *Hope*.

As noted, *Hope* provides that a utility's ROE must, among other things, "be sufficient *to assure confidence in the financial integrity* of the enterprise, so as to *maintain its credit and to attract capital*." 320 U.S. at 603 (emphasis added). But Decision No. 78317, in establishing a base ROE of 8.9% for APS, fails to satisfy these requirements, as indicated by the response of financial analysts and ratings agencies. Indeed, following issuance of the ROO, and before further cuts were made to APS's ROE in amendments to the ROO, APS warned the Commission that ratings agencies would likely cut its ratings if the ROO and proposed amendments were adopted. Spec. Open Mtg. Tr. Vol. I at 17:4-9 (Oct. 4, 2021) (Guldner) ("It is our chamber's understanding that several ratings indices have warned APS that they will downgrade the company's credit rating if the ROO and proposed amendments are adopted. Rating agencies, including Fitch and Moody's, have called the ROO draconian.").[22]

First, on October 7, 2021, Guggenheim downgraded Pinnacle West Capital Corp. ("PNW"), APS's corporate parent, from "buy" to "sell" and its analyst referred to this Commission as "the single most value destructive regulatory environment in the country" for investor-owned utilities. Carl Surran, *Pinnacle West plunges to 52-week low after Guggenheim cuts to Sell*, Seeking Alpha (Oct. 7, 2021), https://seekingalpha.com/news/3750738-pinnacle-west-plunges-to-52-week-low-after-guggenheim-cuts-to-sell (last visited Nov. 16, 2021).

Second, on October 12, 2021, Fitch Ratings ("Fitch") downgraded ratings of both PNW and APS by one notch and continues to maintain a negative outlook for both. In doing so, Fitch characterized the 8.7% ROE as "punitive." *Fitch Downgrades Pinnacle West Capital & Arizona Public Service to 'BBB+'; Outlooks Remain Negative*, Fitch Ratings (Oct. 12, 2021), https://www.fitchratings.com/research/corporate-finance/fitch-downgrades-pinnacle-west-capital-arizona-public-service-to-bbb-outlooks-remain-negative-12-10-2021 (last visited Nov. 16, 2021).

Third, on November 9, 2021, S&P Global similarly downgraded ratings of both PNW and APS by one notch and continues to maintain a negative outlook for both. In doing so, it cited Decision No. 78317 as a precipitating factor. *Pinnacle West Capital*

[22] *See also* Spec. Open Mtg. Tr. Vol. I at 61:8-62:6 (Oct. 4, 2021) (Guldner) ("If you adopt these amendments . . . [w]e would be downgraded by the bond rating agencies because of the business environment in Arizona. Rating agencies have warned us of a downgrade following this case."); Spec. Open Mtg. Tr. Vol. III at 609:21-24 (Guldner) ("The credit rating agencies have warned us that a downgrade is expected following this case. And I think I mentioned we are on negative watch from those agencies.").

Corp. Downgraded To 'BBB+', Outlook Negative, On Arizona Rate Reduction, S&P Global (Nov. 9, 2021) https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2752986 (last visited Nov. 16, 2021).[23]

These responses, including particularly the ratings downgrades by Fitch and S&P Global, are *per se* evidence that APS is unable to "maintain its credit" as required by *Hope*. The ROE established by Decision No. 78317 is thus contrary to law and must be revised.

In addition, these ratings downgrades will result in higher rates for borrowing for APS, the costs of which will be borne by APS's customers in the long term. *See* Spec. Open Mtg. Tr. Vol. I at 61:17-62:8, 259:1-5, 634:7-9 (Guldner) (Oct. 4, 2021) . Consistent with APS's testimony in this case, the punishing ROE imposed by the Commission will thus, over the long term, be counterproductive and increase rates for customers.[24] APS's President/CEO testified that when the Commission creates the wrong balance of interests, it creates "a spiral;" whereby, the utility's credit rating deteriorates, the cost of borrowing money gets higher, the company's stock price falls, requiring the issuance of new equity, and putting continued pressure on stock prices.[25] The result is "harmful to customers, because now it's costing more money to borrow and will eventually get passed through. And equity is the most expensive form of capital. And so the more equity you have to issue and the more dividends you have to pay, the more expensive that is ultimately for customers."[26]

[23] On November 17, 2021, Moody's also downgraded the Company. *See* https://www.moodys.com/research/Moodys-downgrades-Pinnacle-West-to-Baa1-and-Arizona-Public-Service--PR_456814.

[24] *E.g.,* Ex. APS-5 (Guldner Rebuttal) at 4; Ex. APS-6 (Guldner Rejoinder) at 4; Tr. Vol. VIII at 1719-21 (Jan. 26, 2021) (Shipman); Spec. Open Mtg. Tr. Vol. III at 561, 628-633 (Jan. 19, 2021) (Guldner).

[25] Tr. Vol. III at 632-33 (Jan. 19, 2021) (Guldner).

[26] *Id*.

3. An 8.7% All-In ROE Also Unlawfully Violates the Risk Standards of *Hope.*

As noted above, *Hope* provides that a utility is entitled to receive an ROE that is "commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603. But the ROE established by Decision No. 78317 does not reflect appropriately the risks faced by APS. The Commission's decision to set an 8.7% all-in ROE for APS is thus unlawful as contrary to *Hope*.

Decision No. 78317 fails to undertake any articulated analysis of the risks facing APS and does not even acknowledge the fact that the 8.7% ROE established by the Decision is one of the lowest five in the Nation among investor-owned utilities, notwithstanding the unusual risks faced by APS, including the fact that it has substantial investment in and is the operator of nuclear generation,[27] which is widely regarded as having increased business risks as compared to non-nuclear generation providers and distribution only entities. *See* Ex. APS-20 (Bulkley Direct) at 59:11-60:2; Spec. Open Mtg. Tr. Vol. I at 632:17-22 (Guldner) (Oct. 4, 2021); *Re Baltimore Gas & Elec. Co.*, 277 P.U.R.4th 365 (Md. P.S.C. 2009) (noting business rating agencies find nuclear power "risky at best"); *Re United Illuminating Co.*, 2002 WL 31720159 (Conn. D.P.U.C. 2002) ("Generation is more risky than distribution business and nuclear adds to that risk."). Indeed, of the Nation's 93 investor-owned utilities, only four have state-established returns on equity of less than 8.8%. And none of those four utilities own any nuclear generation. Indeed, the median value of these 93 utilities' regulated returns is 9.58%—considerably higher than the ROE established by Decision No. 78317.[28]

As a result, an ROE of 8.7% is nowhere near or "commensurate with returns on investments in other enterprises having corresponding risks" as required by *Hope*, 320 U.S. at 603. *See also Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989) (citing *Hope*, 320 U.S. at 603) ("One of the elements always relevant to setting the rate under

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[27] More particularly, APS is a 29.1% owner as well the operator of the Palo Verde Nuclear Plant. Decision No. 78317 at 46, n. 35 (citing Ex. APS-4 (Guldner Direct) at 15).
[28] Attachment B hereto.

Hope is the return investors expect given the risk of the enterprise."). The 8.7% rate is inadequate as a matter of law.

In addition, by failing even to address the question of whether its chosen ROE for APS was "commensurate with returns on investments in other enterprises having corresponding risks," *Hope*, 320 U.S. at 603, the Commission, therefore, has "entirely failed to consider an important aspect of the problem" before it, *Motor Vehicle Mfrs. Ass'n of U.S., Inc.*, 463 U.S. at 43. Such failures are quintessential arbitrary and capricious agency decision-making. *See id.* ("Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."); *Farmers Union Cent. Exch., Inc. v. FERC*, 734 F.2d 1486, 1520 n.68 (D.C. Cir. 1984) (quoting *Motor Vehicle Mfrs. Ass'n of U.S., Inc.*, 463 U.S. at 43) (FERC ratemaking decision was arbitrary and capricious in part because FERC "'entirely failed to consider an important aspect of the problem' of rate bases."). *Cf. Samaritan Health Sys. v. Ariz. Health Care Cost Containment Sys. Admin.*, 2013 WL 326012, at ¶ 12 (Ariz. Ct. App. Jan. 29, 2013) (quoting *Motor Vehicles Mfrs. Ass'n.* for the proposition that "a rule is arbitrary and capricious if 'the agency has . . . entirely failed to consider an important aspect of the problem . . . .'").[29]

For all these reasons, the Commission's unduly low 8.7% all-in ROE must be set aside.

4. An ROE of 9.47%, on the Other Hand, Is Lawful and Based on Substantial Evidence.

Ms. Bulkley, on behalf of APS, submitted in this proceeding extensive evidence supporting an ROE for the Company of 10.0%. Exs. APS-20 (Bulkley Direct); APS-21

[29] Although *Samaritan Health Sys.* is a Memorandum Decision and not legal precedent, it is cited here "to assist the [Commission] in deciding whether to . . . grant a motion for reconsideration." Ariz. St. S. Ct. R. 111(c)(1)(B). A copy of this decision is attached as Attachment C hereto.

(Bulkley Rebuttal); APS-22 (Bulkley Rejoinder). Ms. Bulkley's recommendation was based on the results of DCF, CAPM, risk premium, and expected earnings analyses. Decision No. 78317 at 305:22-306:1. Notably, Ms. Bulkley's CAPM analysis is based in large part on forward-looking data, and thus avoids the flaws inherent in a fully backward-looking CAPM analysis, as discussed above. *Id.* at 309:16-17, 310:3-5; Ex. APS-22 (Bulkley Rejoinder) at 12:9-11.

The Commission would be on solid ground in adopting such an ROE for APS, as it would satisfy the requirements of *Hope* and *Bluefield*. Indeed, an ROE of 10.0% would "assure confidence in [APS's] financial integrity . . . , so as to maintain its credit and to attract capital," and "be commensurate with returns on investments in other enterprises having corresponding risks." *Hope*, 320 U.S. at 603. In addition, an ROE of 10.0% would place APS's ROE at about the 75th percentile of ROEs of investor-owned utilities in the U.S.—an appropriate placement given APS's risk profile.

Notwithstanding that the evidence and law can support an ROE of 10.0%, APS noted in its exceptions to the ROO that it could accept an all-in ROE of 9.47%, which it believes also comports with the law and the evidence. APS Exceptions to ROO at 40. This value, as explained in APS's Exceptions, is the simple mean of the base ROEs recommended by the four participants that submitted ROE analyses (absent RUCO's 20 b.p. adjustment)—APS (10.0%), Commission Staff (9.4%), FEA (9.3%), and RUCO (8.9%). Decision No. 78317 at 305:9-10. This value too satisfies the requirements of *Hope* and *Bluefield*. And although an ROE of 9.47% would place APS's ROE below the median of ROEs of the 93 investor-owned utilities in the U.S., *see supra*, it would be an appropriate value that, far more than 8.7%, properly reflects the risks faced by APS.

The Commission should thus amend Decision No. 78317 to establish an all-in ROE for APS of at least 9.47%.

IV. DECISION NO. 78317 ARBITRARILY, WITHOUT SUBSTANTIAL EVIDENCE, AND UNLAWFULLY DENIES APS AN APPROPRIATE FVI RETURN.

Decision No. 78317 establishes a return on the FVI of APS's rate base of 0.15%. Decision No. 78317 at 329:7-9. This value is arbitrary, unsupported by substantial evidence, and unlawful. The Commission should thus revise Decision No. 78317 to establish an FVI return in the range of 0.6% to 0.8% which, as detailed herein, is supported by the record in this proceeding.

A. The FVI Return of 0.15% Adopted by Decision No. 78317 Is Arbitrary, Unsupported by Substantial Evidence, and Contrary to Law.

The record of this proceeding contains no support whatsoever for Decision No. 78317's establishment of an FVI return of 0.15%. No participant to this proceeding provided evidence supporting such a value. And Commissioner Olson Amendment No. 1, which modified the ROO to establish this FVI return, provides no articulated reason for selecting this figure. Rather, like the 20 b.p. reduction in ROE discussed above, the 0.15% FVI has no basis in any analysis or economic theory. It is thus arbitrary and contrary to law, and so must be revised. *See, supra*, *Compassionate Care Dispensary, Inc.*, 244 Ariz. at 213; *Turner Ranches & Sanitation Co.*, 195 Ariz. at 577-78; *Sorenson*, 755 F.3d. at 709.

An FVI return of 0.15% is also contrary to the requirement of the Arizona Constitution that rates be set based on the fair value of the utility assets. Ariz. Const. art. 15, § 14. In *Chaparral City Water Co. v. Ariz. Corp. Comm'n*, 2007 WL 9710985 (Ariz. Ct. App. 2007) ("*Chaparral City*"), the Court of Appeals vacated a Commission decision that "engage[d] in a superfluous mathematical exercise," *id.* at ¶ 17, through which it effectively set a utility's "revenue requirements and rates, . . . based not on the fair value of its property, but on its [original cost]," *id.* at ¶ 14.[30] This, the Court held, "does not comport with the Arizona Constitution," *id.*, and "is inconsistent with Arizona

[30] Although *Chaparral City* is a Memorandum Decision and not legal precedent, it is binding on the parties in that case, which includes the Commission, and is cited for that purpose. In addition, *Chaparral City* is offered because it accurately summarizes the history of the Commission's action in that matter. *See* Ariz. St. S. Ct. R. 111. A copy of *Chaparral City* is attached to APS's Post-Hearing Brief, filed in the present proceeding on April 30, 2021.

law," *id.* at ¶ 17. An FVI return of 0.15% is similarly contrary to the Arizona Constitution and law because it results in no meaningful difference between the return on the fair value of the utility assets and what would be the return if based on original cost alone. Indeed, an FVI return of 0.15% is so negligible as to be tantamount to an FVI return of zero, and thus renders effectively meaningless the Arizona State Constitution requirement that returns be set based on fair value and not original cost.

B. An FVI Return of 1.28%, on the Other Hand, Is Supported by the Evidence.

An FVI return of 1.28%, on the other hand, is both founded in economic logic and consistent with the law and the evidence, unlike the arbitrary 0.15% FVI return value in the Decision. Indeed, an FVI return of 1.28% represents the risk-free return on investment, as calculated by APS's witness Ann Bulkley. Decision No. 78317 at 324:15-16; Ex. APS-21 (Bulkley Rebuttal) at 12:5-6, 20:4-5.

Indeed, an FVI return equal to the risk-free rate should be the constitutional minimum because FVI represents untapped investment in utility assets. Stated differently, the FVI return must compensate the owner of utility assets for the opportunity cost of not selling assets or leveraging existing assets. Thus, there is strong support in the record for setting the FVI at 1.28%, which Ms. Bulkley demonstrates is the real risk-free rate of return on investment. Decision No. 78317 at 324:15-16; Ex. APS-21 (Bulkley Rebuttal) at 12:5-6, 20:4-5.

Notably, Christopher Walters, witness for FEA, found the real risk-free rate to be 1.30%, although he halved this value in recommending an FVI return of 0.65%, based on past practice of the Commission. Decision No. 78317 at 325:26-326:1. And like Ms. Bulkley, Mr. Walters based this risk-free rate on the average yield of long-term U.S. Treasury securities. *Id.* at 325:24-25. Witnesses for RUCO and Staff, however, found the real risk-free rate to be considerably lower—namely, 0.28% and 0.60%, respectively. *Id.* at 326:10, 327:8. But, as explained by Ms. Bulkley, the RUCO and Staff values should not be relied upon because they were based on short-term bond yields, whereas utiltiy investments are long-lived and, thus, longer-term projections should be used. Ex. APS-21 (Bulkley Rebuttal) at 51:22-52:6, 68:15-69:7.

This said, APS ultimately proposed an FVI return of 0.6% to 0.8% even though the record supported a far greater rate. Decision No. 78317 at 324:17-18; APS Exceptions at 45. Accordingly, adoption of such a rate would not only be permissible, but is Constitutionally required to sufficiently compensate the Company under existing precedent.

V. <u>DECISION NO. 78317 ARBITRARILY, WITHOUT SUBSTANTIAL EVIDENCE, AND CONTRARY TO LAW DENIES APS FULL COST RECOVERY OF THE REGULATORY ASSET ASSOCIATED WITH THE RETIRED NAVAJO GENERATING STATION.</u>

In Decision No. 78317, the Commission disallowed 15% recovery of APS's regulatory asset associated with the retirement of the NGS. Decision No. 78317 at 203:5-9, 432:14-15. More particularly, the Commission determined that it was "appropriate under the circumstances not to allow full recovery of the regulatory asset" and, instead of allowing a cost-of-debt rate of return (which the Commission deemed unnecessarily complex), decided that it was "more appropriate to . . . record 15% of the annual amortization for the NGS below the line as non-operating expenses, as it would provide a similar, but simpler economic disallowance." *Id.* at 202:27-203:4. The Commission inappropriately relied on its recent Decision No. 77856 to support this determination. For the reasons discussed below, this disallowance is arbitrary, contrary to law, and unsupported by substantial evidence. Instead, the ACC should permit APS 100% recovery of the NGS regulatory asset, consistent with past ACC precedent and the substantial evidence in the record.

Under the Arizona Constitution, the Commission must prescribe "just and reasonable" rates for regulated utilities. Ariz. Const. art. 15, § 3. The Commission itself has recognized and endorsed "the fundamental ratemaking principle that a public utility must be allowed an opportunity to earn a reasonable return on its prudent investments …." Decision No. 72047 (Jan 6, 2011) at 37, Ariz. Corp. Comm'n Docket No. W-01303A-09-

0343 (*In the Matter of the Application of Ariz.-Am. Water Co.)*. Thus, absent a finding of imprudence, the ACC cannot reasonably deny a utility recovery of and on its investment.

Historically, and as discussed below, the ACC has treated retired asset recovery in the same way that it has treated currently-operational assets. Under Ariz. Admin. Code R14-2-103(A)(3)(l), "[a]ll investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time . . . ."

In Decision No. 78317, the Commission disallowed 15% recovery of the NGS regulatory asset without purporting to make any finding of imprudence. No participant nor the ACC's Staff challenged the prudency of the investment. Nor could they. NGS was previously found by the Commission to be prudent and the investment costs of the plant were in rate base for decades while the plant was in operation. Any attempt now to retroactively deem the NGS investment imprudent based on subsequent developments would be an impermissible application of hindsight in violation of the regulation.

In Decision No. 78317, there was no finding and no record evidence to support the theory that any costs or investments related to NGS and its operations, closure, or the regulatory asset itself are imprudent, and thus at a minimum the presumption of prudence controls. It necessarily follows that APS is entitled to recover a return of and on *the full amount of* its NGS prudent investment as any decision to the contrary is unsupported by record evidence.

Further, the ACC's reliance on its recent decision in TEP's rate case is inappropriate as that decision is anomalous and contrary to Commission precedent. Moreover, it occurred after the retirement of NGS and the creation of APS's regulatory asset. *See* Decision No. 77856 at 93-95. The TEP decision is contrary to prior ACC precedent that permitted full recovery of prudently incurred retired plant costs. *See*, *e.g.*, Decision No. 73183 (approving a settlement that allowed recovery of and on the Four Corners Units 1-3 book value); Decision No. 69663 (2007) (approving full recovery for

West Phoenix's Unit 4, an oil/gas fired steam unit using an accounting mechanism called reserve rebalancing that effectively allows both a recovery of and a return on the remaining book value); Decision No. 71448 (2009) (allowing full recovery of Childs-Irving hydro generating unit using a reserve rebalancing mechanism).

Decision No. 78317 thus violates Arizona law regarding retroactive application of new rules of law that upset reasonable investment-backed expectations, *see supra* Section II, and is arbitrary because the Commission has failed to acknowledge or justify its change of position. As the U.S. Supreme Court has explained, "the requirement that an agency provide reasoned explanation for its action" "ordinarily demand[s] that it display awareness that it *is* changing position. An agency may not, for example, depart from a prior policy *sub silentio* . . . . And of course the agency must show that there are good reasons for the new policy." *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

For these reasons, Decision No. 78317 should be revised to provide APS full recovery of the NGS regulatory asset. Any other outcome is aribtrary, contrary to law, and unsupported by substantial evidence.

VI. DECISION NO. 78317 ARBITRARILY AND WITHOUT SUBSTANTIAL EVIDENCE REDUCES APS'S PREPAID PENSION ASSET FOR PURPOSES OF RATE BASE RECOVERY.

In Decision No. 78317, the Commission decided to "normalize" the net prepaid pension asset, resulting in a reduction to APS's rate base of $76.45 million and a corresponding $3.12 million increase to APS's operating expenses. Decision No. 78317 at 182:19-27. This normalization adjustment was not proposed by any participant to these proceedings and is unlawful, arbitrary, and unsupported by substantial evidence. The Commission should correct these errors and permit APS to include 100% of its prepaid pension expense for the test year in rate base.

A. The ACC's Rationale for "Normaliz[ing]" the Prepaid Pension Asset Is Insufficient as a Matter of Law, Arbitrary, and Without Substantial Evidence.

Other than a single sentence stating that "APS's prepaid pension asset, net of changes in SERBP liability, is significantly higher for the [test year] than in preceding years (2015-2018), as shown below (all $ in millions)," Decision No. 78317 at 182:11-12, Decision No. 78317 provided no analysis, supporting evidence, or justification for its assertion that normalization of the prepaid pension asset is appropriate because the value of the asset in the test year is higher than the average of certain previous years. Moreover, no participant in this proceeding or Commission Staff offered any evidence or other basis for this outcome at any time throughout the proceeding. The Commission's failure to provide a reasoned explanation for its decision is arbitrary. *Compassionate Care Dispensary, Inc.*, 244 Ariz. at 213 (quoting *Motor Vehicle Mfrs. Ass'n of U.S., Inc.*, 463 U.S. at 43) ("An agency acts arbitrarily and capriciously when it does not examine 'the relevant data and articulate a satisfactory explanation for its action, including "a rational connection between the facts found and the choice made."'"); *Saguaro Healing LLC v. State*, 249 Ariz. 362, 368-69 (App. 2020) (same).

A decision regarding whether to allow full recovery of a prepaid pension asset is an accounting issue that should be resolved in a manner that is "properly informed by the testimony of the accounting witnesses." *Turner Ranches Water & Sanitation Co. v. Ariz. Corp. Comm'n*, 195 Ariz. 574, 808 (App. 1999). Decision No. 78317 acknowledges that the "[a]ccounting and ratemaking treatment of pension and OPEB costs is complicated." Decision No. 78317 at 181:22. Yet no accounting or other expert witness presented any evidence to suggest that adjustment of the prepaid pension asset in the manner required by the Decision is an appropriate treatment in these circumstances, and APS's accounting witness, Ms. Blankenship, supported full recovery of the asset. Moreover, the Decision cites no evidence to support its conclusion, which is contrary to the record. Five-year normalization of the prepaid pension asset was not discussed throughout the case and was not proposed by any party. Rather, it was proposed by the Administrative Law Judge

(2019) without evidentiary support, and was approved by the Commission without any support from any expert in this field. The Decision thus lacks supporting substantial evidence.

B. The ACC Mischaracterizes Its Action as "Normalization"—It Is Really Just an Arbitrary Disallowance That Fails to Recognize an Upward Trend Over Time.

Decision No. 78317 mischaracterizes its reduction of the prepaid pension asset as normalization when in reality, the ruling is simply a disallowance that arbitrarily disregards undisputed record evidence establishing the asset's increasing value over time. Normalization is a statistical technique used to adjust an anomalous value that is otherwise out-of-line with other measurements as a result of known and measurable circumstances. For example, it is standard in the electric industry to "weather-normalize" load forecasts to account for anomalous weather conditions in any given year. *See*, *e.g.*, Decision No. 77270 (June 27, 2019) at 7, Ariz. Corp. Comm'n Docket No. E-01345A-19-0003 (*In the Matter of the Rate Review of Ariz. Pub. Serv. Co.*) (explaining that *pro forma* adjustments in a rate case include "weather normalization, plant additions, interest synchronization and income tax expense normalization"). Similarly, the Commission has normalized data when a certain activity had occurred for only a portion of a year and needed to be normalized over the entire year. *See Tucson Elec. Power Co. v. Ariz. Corp. Comm'n,* 132 Ariz. 240, 246 (1982) (in banc) (explaining that because "Tucson Electric Power only sold power to FERC jurisdictional customers during the last seven months" that "[i]t was necessary . . . for the Commission to adjust the . . . figures as if those sales were made during the entire year. This is called a 'normalization' process.").

But there is no justification for applying such an approach to valuation of an asset that has been growing steadily in value over time. There is nothing anomalous or unusual that needs to be adjusted by reference to lower values in the past. Instead, the Commission has intentionally reduced the value of the asset merely because its value is growing over time, an inappropriate and arbitrary basis for declining to credit APS with the full value of this asset in order to arrive at a particular, and specifically lower, outcome. This is a pure disallowance, and it is wholly arbitrary. It should be set aside.

VII. CONCLUSION

For the foregoing reasons, APS requests that the Commission reconsider Decision No. 78317 and revise it by:

- Permitting APS to include in rate base the full value of APS's SCRs Investment, including the SCRs Deferral;
- Removing the 20 basis point reduction to APS's ROE;
- Establishing an ROE for APS of at least 9.47% (rather than 8.7%);
- Establishing an FVI return of 0.6% to 0.8% (rather than 0.15%);
- Granting APS full recovery of the NGS regulatory asset (rather than a 15% reduction); and
- Permitting the full test year value of APS's prepaid pension asset to be included in rate base (rather than "normalizing" it through averaging that value with those of prior years).

RESPECTFULLY SUBMITTED this 24th day of November 2021.

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AC

Attachment A

Decision No. 78317 establishes a new, retrospective prudence analysis out of whole cloth. More particularly, it requires utilities to perform a prudency evaluation at every financing stage of a project. The relevant "duty" was articulated by the Commission as follows (emphasis added).

> We believe that a utility has a duty to monitor the economics of its investments in a project from the inception of the project and until the project is completed and that *each investment made along the way is subject to a prudency determination*. We also believe that a utility has a duty to alter its choices and its course for a project if doing so makes sense economically and is in the public interest, even if altering the course may not be as advantageous to the utility's shareholders as completing the project would be. A utility has a duty not only to its shareholders but also to its ratepayers and the public."

This appendix contains a collection of Arizona Corporation Commission Decisions that show the Commission's prior consistent practice of conducting a prudency inquiry on a *total investment basis*, rather than as a piece-meal, time of financing analysis as called for by Decision No 78317.

1. *In re Arizona Pub. Serv. Co.*, Decision No. 55931, 1988 WL 391394 (Ariz. C.C. Apr. 1, 1988).

    a. Arizona Public Services Company filed an application for approval of rates and charges to increase revenues. *Id.* APS proposed an adjusted original cost rate base of $3.3 billion. *Id.* RUCO sought to exclude from the original cost rate base a portion of the cost of APS's Palo Verde Unit 2 as being "imprudent capacity," which would include an adjustment to rate base and to depreciation expense. RUCO's witness testified that "APS should not have continued with Unit 2, but should have stopped construction or sold its ownership share in that Unit." *Id*.

    b. APS rebutted this testimony, critiquing the RUCO witness's "retrospective regression analysis." *Id.* The Commission rejected RUCO's testimony, finding it "not sufficient support for a finding that construction of and retaining the ownership interest in Palo Verde 2 was imprudent, 'when viewed in light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made.'" (quoting A.C.C. Rl4–2–103(A)(3))). The Commission denied RUCO's imprudence adjustment, but "emphasize[d]" that their opinion of the testimony did "not mean that [they] have decided that APS's decisions with respect to Palo Verde were in fact prudent." *Id.*

c. Instead, the Commission reserved its ultimate prudence determination for the Palo Verde prudence audit. *Id.* The Palo Verde prudence audit was subsequently resolved by a settlement agreement. The agreement stipulated that it was not "an admission by APS . . .that there was imprudence in the planning, construction, or operation of Palo Verde." *Id.*

d. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

2. *In re Arizona Elec. Power Coop., Inc.*, Decision No. 58405, 1993 WL 449348 (Ariz. C.C. Sept. 3, 1993).

a. Arizona Electric Cooperative (AEPCO) filed an application for a permanent increase in electric rates. *Id.* Staff proposed to exclude from rate base costs "associated with the acquisition and remodeling" of a headquarters complex. *Id.*

b. The Commission noted that "Decision No. 57848 (May 14, 1992) approved the financing for construction of [AEPCO's] new headquarters complex, and in response to a Finding of Fact, Staff re-examined the AEPCO headquarters building project." Decision No. 57848 contained an explicit finding of fact authorizing this re-examination: "Staff analyzed the application and recommended the following: the application be approved without a hearing: *the costs of the project be thoroughly re-examined at AEPCO's next rate case to determine whether the costs were reasonable and prudent*; and that AEPCO file future financing applications before it proceeds with the project for which financing approval is requested." Decision No. 57848, *In re AEPCO*, Docket No. U-1773-91-391, at 4 (May 14, 1992).

c. In Decision No. 58405, the Commission found that "the $581,000 in costs associated with the acquisition and remodeling of AEPCO's headquarters complex was prudent." *Id.* Staff "used the replacement method to determine the value" of the property purchased and claimed that "AEPCO spent $209,450 more than it should have spent for the purchase." *Id.* AEPCO responded with "evidence showing that it obtained an appraisal from … a real estate appraisal and consulting firm … prior to making its decision to purchase Building 1000" that supported the acquisition price, and that it "ran an economic analysis and determined that continued leasing of the building would be $600,000 - $1,000,000 more expensive than [the] purchase." *Id.*

d. Staff also argued that the construction costs were excessive, based on "average construction costs applied to square footage of construction." *Id.* AEPCO responded that it had "commissioned a Master Plan to determine its needs for the next 10-20 years; it hired a professional architect to design and oversee the construction project; it commissioned an engineering study to evaluate and make provision for the Benson area soil conditions to prevent another building collapse; it competitively bid the project; and it selected the low bidder to complete the work." *Id.* The Commission concluded that "the total construction costs were reasonable" and accordingly permitted the full amount to be included in rate base. *Id.*

e. This project was analyzed on a total project basis. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

3. *In re Arizona-American Water Co.*, Decision No. 70209, 2008 WL 828357 (Ariz. C.C. Mar. 20, 2008).

   a. Arizona-American Water Company filed an application for an increase to its rates for utility service in two Wastewater districts. *Id.* at *1. The company proposed to include in rate base the costs of a dechlorination upgrade totaling $239,827, for which no prudence determinations had yet been made by the Commission. *Id.*

   b. RUCO sought to exclude the dechlorination upgrade from rate base as not being used and useful during the test year. The Commission found that the entirety of a dechlorination upgrade was "a legitimate, prudence investment, and that its deferred cost should be allowed in rate base at this time." *Id.*

   c. This upgrade was analyzed on a total project basis; there was no suggestion that Arizona-American should reevaluate the prudency of operating the Tolleson Wastewater Treatment Plant. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing an ongoing project with each new expenditure after the decision to proceed with the investment has been made.

4. *In re Arizona-American Water Co., Inc.*, Decision No. 70372, 2008 WL 2487031 (Ariz. C.C. June 13, 2008).

   a. Arizona-American Water Company filed an application to determine the fair value of its plant and property and to increase its rates and charges in its Anthem Water and Anthem/Ague Fria Wastewater districts. *Id.* Arizona-

American had previously expanded its Northwest Plant to accommodate flows from the Northeast Agua Fria service area of the Anthem/Agua Fria Wastewater District in addition to Sun City West flows. *Id.* A previous Commission decision allocated 68 percent of the costs to the Sun City West rate base, and did not determine how the other 32 percent should be allocated. *Id.*

b. In this case, Staff and Arizona-American recommended allocating the remaining 32 percent to the Anthem/Ague Fria Wastewater district. *Id.* RUCO recommended rejecting inclusion of any amount in the rate base, claiming that the 32 percent reflected "'excess capacity'" that "'will be used to service the needs mostly of future … customers" and thus current "ratepayers should not have to pay for service they do not benefit from." *Id.* RUCO further argued that "most of the Northwest Plant expansion is not used and useful" and that "there are uncertainties associated with growth projections" that should not have to be borne by ratepayers. *Id.* According to RUCO, the question for the Commission was whether "excess capacity should be recovered in rates." *Id.*

c. Staff stated that RUCO's argument was "inconsistent with ratemaking principles, the rules of the Commission, and accepted industry practices" and that the Commission had "expressly rejected" those arguments in its "prudently invested" definition. *Id.*

d. The Commission rejected RUCOs arguments, because "the factors that RUCO argues in support of disallowing the full allocation of the Northwest Plant" are "expressly rejected in the Commission's definition of 'prudently invested.'" *Id.* The Commission explained that while "prudence is determined after the utility makes its investment," "Commission rules clearly provide that '[a]ll investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." *Id.* (quoting A.A.C. R14-2-103A.3(1)).

e. The Commission expressly rejected "RUCO's arguments against inclusion of the capacity," stating that "the Company prudently *decided to make the investment necessary in 2004* to expand the capacity . . . in consideration of the *known* peak daily flows that occurred prior to the expansion . . ." and found that RUCO's argument "fail[ed] to address the requirement that prudence be determined based on what a utility knew or reasonably should have known *at the time investment decisions are made*." *Id.*

f. The Commission further found that "the *entire* Northwest Plant is 100 percent used and useful," rejecting RUCO's arguments that the plant's excess capacity should not be included in the rate base because it was of no benefit to current ratepayers. *Id*. (emphasis added). The Commission explained that uncertainty in projections alone was not sufficient to show that rates were inequitable and unfair, and that reliance on the "five year planning horizon that is the generally accepted means for utilities to make wastewater plant investment decisions" in order to anticipate potential future capacity needs was appropriate, despite the "uncertainty inherent to growth projections." *Id.*

g. The expansion was analyzed on a total project basis. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

5. *In re Litchfield Park Serv. Co*., Decision No. 72026, 2010 WL 5143865 (Ariz. C.C. Dec. 10, 2010).

a. Litchfield Park Service Company filed an application for rate increases for its wastewater and water services. *Id.* Litchfield proposed an original cost rate base and fair value rate base, with which RUCO disagreed. *Id.* Litchfield had previously completed construction on the Palm Valley Water Reclamation Facility, for approximately $18 million. Five years later, significant upgrades were performed, for $7 million, after a series of spill events. *Id.*

b. RUCO sought to disallow half of the upgrade costs as "not just or reasonable," RUCO's Reply Brief, Docket No. W-01427A-0-0120, at 3, because RUCO attributed the upgrades as being "necessitated by design errors." Decision No. 72026. Litchfield asserted the entire upgrade cost should be included because it was "undisputed that the upgrades were necessary and prudent and are used and useful," and that "RUCO's disallowance would have a dramatic chilling effect on utility acquisitions in Arizona and would be confiscatory." *Id.* The staff agreed with the company, because "every utility must rely on engineering estimates in planning its facilities and that if a plant is designed to meet estimated conditions, but actual operational conditions are different, the cost of the repairs and the number of total projects needed to increase reliability are irrelevant." *Id.*

c. The Commission found RUCO's argument without merit, because the upgrades met all regulatory requirements, and were necessary. In analyzing the amount to be included, the Commission stated that "[t]he entire cost of the plant, including both the original construction cost and the upgrades cost, is reasonable for a plant of its size. The plant upgrades were a prudent expenditure, are used and useful, and are in service and benefiting [Litchfield's] customers. It is just, reasonable, and appropriate to allow [Litchfield] to include the entire cost of the upgrades, minus the identified retirements, in plant in service and rate base, and we will do so." *Id.*

d. The plant upgrades were analyzed on a total project basis, and not individually based on time of investment. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

6. *In re Arizona-American Water Co.*, Decision No. 72047, 2011 WL 121179 (Ariz. C.C. Jan. 6, 2011).

a. Arizona-American Water Company filed an application for rate increases in a number of water districts. *Id.* Part of the case involved a dispute over funds paid by Arizona American to Pulte, pursuant to a previously entered Infrastructure Agreement concerning the construction and funding of new water and wastewater infrastructure. *Id.*

b. "In 1997, Arizona-American's predecessor Citizens Utilities Company ("Citizens") and Del Webb Corporation ("Del Webb"), the predecessor of Pulte Corporation ("Pulte"), and subsidiaries of Citizens and Del Webb entered into an Agreement for the Villages at Desert Hills Water/Wastewater Agreement ("Infrastructure Agreement" or "Agreement") regarding the construction and funding of the extensive new water and wastewater infrastructure required to serve the master-planned community of Anthem. Under the Agreement, Del Webb was to fund much of the water and wastewater infrastructure, and Arizona-American would eventually have to refund Del Webb's advanced funds in accordance with Exhibit B of the Agreement, with a large balloon payment when build-out occurred. Only after projects were completed and refunds made to Pulte did the plant become eligible for inclusion in rate base." *Id.*

c. The Anthem Community Council, an intervenor, sought to have the refunds paid under the agreement by Arizona-American to Pulte for their advance payments to build out the infrastructure that was used and useful, be excluded from the rate base. *Id.* The Council sought to have any payments which had not been shown "to be reasonable and proper" be "permanently excluded from rate base and denied any rate base recognition." *Id.*

d. The Commission stated that it found "no evidence in the record of this proceeding that the refund payments, which paid for infrastructure that is used and useful and necessary in the provision of service to the districts, were not reasonable and proper." *Id.* It highlighted that the "system was an expensive one to build, that all the plant is used and useful, and that the infrastructure costs are a legitimate cost of service." *Id.* The Commission accordingly declined to mandate a "disallowance of Arizona-American's prudently made equity investments in the infrastructure required to provide reasonable and adequate water and wastewater utility service to the Anthem districts. In conformance with the fundamental ratemaking principle that a public utility must be allowed an opportunity to earn a reasonable return on its prudent investments, the equity investment that the Company made in the Anthem districts' infrastructure in the form of advance refunds will be allowed in rate base." *Id.*

e. This project was analyzed on a total project basis. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

7. *In re Ray Water Co., Inc.*, Decision No. 74084, 2013 WL 5408674 (Ariz. C.C. Sept. 23, 2013).

   a. Ray Water Company filed an application for a permanent rate increase. *Id.* at *1. As part of the application, the company included costs associated with construction of a well, which staff had removed as being excess capacity. *Id.* at *4-5. The Company installed the well due to the poor structural conditions of other wells, to provide reliable water supply, maintain operational flexibility for routine maintenance, and to provide water in the event another well failed. *Id.* at *7.

   b. In Decision No. 71691 (May 2, 2010), "the Commission cautioned the Company that Staff's position that the well was not currently needed should put RWC on notice that the new plant could be deemed not used and useful in a future rate case and disallowed from rate base." *Id.* at *4.

   c. Staff sought to exclude the costs of the well, in addition its depreciation and express, from rate base as representing excess capacity. *Id.* at *5. Ray Water Company's management witnesses disputed these conclusions, "assert[ing] that the installation of Well No. 8 was prudent and reasonable," and that the company "reached the decision to construct the new well after consultation with engineers who had assessed the condition of the Company's existing wells" while "stressing that she would not have installed the well unless she believed it was vital to the Company's provision of safe and reliable service to customers." *Id.*

d. The Commission found the total investment of $459,450 for the well installation, installed as a "proactive effort[] to replace a failing well before provision of water to customers was jeopardized" was appropriate, was not excess capacity, and so was "used and useful and should be included in [the] rate base." *Id.* at *4, 8.

e. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

8. *In re Southwest Gas Corporation*, Decision No. 77850, 2020 WL 8024093 (Ariz. C.C. Dec. 17, 2020).

a. Southwest (SWG) filed an amended rate application for adjustment to its rates and charges, including to continue its Vintage Steel Pipe ("VSP") replacement program and its associated cost recovery mechanism. *Id.* at 2. Southwest sought to include $100 million in plant costs associated with the VSP replacement program, which was a proactive replacement of pre-1970 vintage pipes, in its post-test-year plant adjustment, for which no prudence determinations had yet been made by the Commission. The VSP program was intended to allow Southwest to proactively replace pipes before they became unsafe or were required by regulation to be replaced. *Id.* at *18

b. The VSP program had been approved in *In Re Southwest Gas Corporation*, Decision No. 76069, Docket No. G-01551A-16-0107 (Ariz. C.C. Apr. 11, 2017). That decision allowed SWG "to implement its proposed Vintage Steel Pipe ("VSP") Replacement Program, with the annual surcharge adjustment capped at $0.015 per therm per year." *Id.* at 7. The decisions directed "SWG, Staff and RUCO [to] develop a [Plan of Administration]." *Id.* at 7-8.

c. In this Decision, No. 77850, the Commission determined that it would discontinue the VSP program, because "the evidence does not establish the existence of an immediate public health and safety concern regarding the condition of the vintage steel pipe on the Company's system." *Id.*

d. Arizona Grain, an intervenor, sought to prevent recovery of the $100 million VSP costs at issue, arguing "that although the Commission authorized the VSP program in the Company's last rate case, the Commission did not guarantee permanent recovery of the resulting expenditures." Arizona Grain further argued that "the VSP program investments were not prudently incurred because the replaced pipeline was otherwise 'perfectly functioning,' and 'the replacements were not required by public health or safety.'" *Id.* at *19

e. The Commission found "that the [post-test-year plant] additions associated with VSP program plant were prudently incurred pursuant to a Commission-approved program and [Plan of Administration], are used and useful in the provision of gas utility service to customers, and should therefore be included in rate base. In this regard, we note that Staff examined SWG's gas distribution system and equipment and concluded that, except as otherwise reflected in Staff's recommended adjustments, "all projects and equipment were found to be used and useful." *Id.* This was despite finding the VSP program "should be discontinued at this time," because there was "no evidence that SWG failed to comply with the terms and conditions of the Commission-approved VSP program, including the POA" in replacing vintage pipe.

f. The prudency of the VSP program adjustments was analyzed in reference to the Commissions approval in Decision No. 76069 of the program, and the Plan of Administration. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project. Here, the Commission determined that going forward, the VSP program should be discontinued, but that did not affect the prudency determination on investments already made.

9. *In re Arizona Water Co.*, Decision No. 77956, 2021 WL 1550468 (Ariz. C.C. Apr. 15, 2021).

a. Arizona Water Company filed an application for adjustments to its rates, including a request to include 12 months of revenue-neutral post-test-year plant investments. for which no prudence determinations had yet been made by the Commission.. *Id.* at *1. The company argued that the additions, totaling nearly $22 million across dozens of projects, were prudent plant investments to provide safe and adequate water supply.

b. The company stated that the post-test-year projects "cumulatively are a significant and substantial cost, critical to the provision of water service, prudently incurred, and benefitting current customers," and the Commission found that the entirety of the $21.7 million across the dozens of projects "were prudently incurred, are used and useful in the provision of water utility service to customers, are revenue-neutral, and their inclusion outweighs the financial harm to customers, and, as a result, should be included in rate base." This was based on Staff's review of the 47 projects, which involved a "Project Description," the "Total Cost" for each project, a summary conclusion by Staff that "the PTY capital improvement projects . . . totaling $21,707,426 are reasonable and necessary, are currently in operation, and are used and useful to the water systems provision of service." Staff Direct Testimony of Frank M. Smaila, Docket No. W-01445A-19-0278, Ex. FMS at 53-60.

c. There is no indication that projects were analyzed on anything other than a total project basis. Staffs evaluation and recommendation, which the Commission wholly accepted, did not differentiate between projects, or inquiry into the timing of investment decision. The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

10. *In re Bermuda Water Co., Inc.*, Decision No. 77976, 2021 WL 2337510 (Ariz. C.C. Apr. 29, 2021).

a. Bermuda Water Company filed an application to determine the fair value of its plant and property, for an increase in rates and charges, and related approvals. The application contained a proposed original cost rate base of $13.2 million, including five post-test-year projects totaling $871,777 for which no prudence determinations had yet been made by the Commission. *Id.* at *1, 4

b. Commission staff reviewed the five post-test-year projects which ranged from $68,625 to $358,451, which entailed summarizing the costs incurred, and the repair, rehabilitation, or upgrade undertaken. Staff then "conclude[d] that the PTYP projects . . . were prudently procured and are "used and useful" in the Company's provision of service." Staff Direct Testimony of Sujana Attaluri, Docket No. W-01812A-20-0109, at 15-18.

c. The Commission noted that "Staff reviewed the five [post-test year plant] projects and concludes that the projects were prudently procured and are used and useful," and found that the original cost rate base the company and staff agreed to was "reasonable and appropriate and should be adopted." The Commission nowhere stated or suggested that utilities are subject to an ongoing obligation to reexamine the prudence of continuing to invest in an ongoing project each time a further expenditure is made, even after the utility has made the decision to proceed with the project.

Attachment B

Allowed ROEs of Electric Utilities by ROE Magnitude

	State	Ticker	Company	Authorized ROE (%)
1	Alaska	AVA	Alaska Electric Light Power	11.95
2	California	SRE	San Diego Gas & Electric Co.	11.10
3	Florida	NEE	Florida Power & Light Co.	10.55
4	Georgia	SO	Georgia Power Co.	10.50
5	Kansas	EVRG	Evergy Kansas South	10.40
6	Ohio	AEP	Ohio Power Co.	10.30
7	California	PCG	Pacific Gas and Electric Co.	10.25
8	Florida	CPK	Florida Public Utilities Co.	10.25
9	Florida	NEE	Gulf Power Co.	10.25
10	Florida	EMA	Tampa Electric Co.	10.25
11	Michigan	WEC	Wisconsin Public Service Corp.	10.20
12	Michigan	WEC	Wisconsin Electric Power Co.	10.10
13	Mississippi	ETR	Entergy Mississippi LLC	10.07
14	Iowa	LNT	Interstate Power & Light Co.	10.02
15	Arizona	PNW	Arizona Public Service Co.	10.00
16	California	AQN	Liberty Utilities (CalPeco Ele	10.00
17	California	BRK.A	PacifiCorp	10.00
18	Massachusetts	ES	Western Massachusetts Electric	10.00
19	Ohio	AES	AES Ohio	10.00
20	Ohio	AEP	Columbus Southern Power Co.	10.00
21	Wisconsin	LNT	Wisconsin Power and Light Co	10.00
22	Louisiana	ETR	Entergy Gulf States LA LLC	9.95
23	Louisiana	ETR	Entergy Louisiana LLC	9.95
24	Michigan	CMS	Consumers Energy Co.	9.90
25	Michigan	DTE	DTE Electric Co.	9.90
26	Michigan		Upper Peninsula Power Co.	9.90
27	Wyoming	BKH	Cheyenne Light Fuel Power Co.	9.90
28	Florida	DUK	Duke Energy Florida LLC	9.85
29	Pennsylvania	UGI	UGI Utilities Inc.	9.85
30	Tennessee	AEP	Kingsport Power Company	9.85
31	Ohio	DUK	Duke Energy Ohio Inc.	9.84
32	Texas	SRE	Oncor Electric Delivery Co.	9.80
33	Wisconsin	MGEE	Madison Gas and Electric Co.	9.80
34	North Carolina	D	Virginia Electric & Power Co.	9.75
35	Indiana	DUK	Duke Energy Indiana, LLC	9.70
36	Massachusetts	UTL	Fitchburg Gas & Electric Light	9.70
37	Nevada	BRK.A	Sierra Pacific Power Co.	9.70
38	Maryland	FE	The Potomac Edison Co.	9.65
39	Montana	NWE	NorthWestern Corp.	9.65
40	Texas	PNM	Texas-New Mexico Power Co.	9.65
41	Delaware	EXC	Delmarva Power & Light Co.	9.60
42	North Carolina	DUK	Duke Energy Carolinas LLC	9.60
43	North Carolina	DUK	Duke Energy Progress LLC	9.60
44	New Jersey	EXC	Atlantic City Electric Co.	9.60
45	New Jersey	FE	Jersey Cntrl Power & Light Co.	9.60
46	New Jersey	PEG	Public Service Electric Gas	9.60
47	New Mexico	PNM	Public Service Co. of NM	9.58
48	New Mexico	XEL	Southwestern Public Service Co	9.54
49	Arizona	FTS	UNS Electric Inc.	9.50
50	Hawaii	HE	Hawaii Electric Light Co	9.50
51	Hawaii	HE	Hawaiian Electric Co.	9.50
52	Hawaii	HE	Maui Electric Company Ltd	9.50
53	Maryland	EXC	Baltimore Gas and Electric Co.	9.50
54	New Hampshire	UTL	Unitil Energy Systems Inc.	9.50
55	New Jersey	ED	Rockland Electric Company	9.50
56	Oregon	POR	Portland General Electric Co.	9.50
57	South Carolina	D	Dominion Energy South Carolina	9.50
58	Arkansas	AEP	Southwestern Electric Power Co	9.45
59	Kentucky	PPL	Kentucky Utilities Co.	9.43
60	Kentucky	PPL	Louisville Gas & Electric Co.	9.43
61	Minnesota	OTTR	Otter Tail Power Co.	9.41
62	Idaho	AVA	Avista Corp.	9.40
63	Nevada	BRK.A	Nevada Power Co.	9.40
64	Oklahoma	AEP	Public Service Co. of OK	9.40
65	Texas	AEP	AEP Texas Inc.	9.40
66	Texas	CNP	CenterPoint Energy Houston	9.40
67	Washington		Puget Sound Energy Inc.	9.40
68	Texas	SRE	Sharyland Utilities L.L.C.	9.38
69	Colorado	BKH	Black Hills Colorado Electric	9.37
70	Louisiana	ETR	Entergy New Orleans LLC	9.35
71	Colorado	XEL	Public Service Co. of CO	9.30
72	Kansas	EVRG	Evergy Kansas Central Inc.	9.30
73	Kansas	EVRG	Evergy Metro Inc	9.30
74	Kentucky	AEP	Kentucky Power Co.	9.30
75	New Hampshire	ES	Public Service Co. of NH	9.30
76	District of Columbia	EXC	Potomac Electric Power Co.	9.28
77	Rhode Island	NG.	Narragansett Electric Co.	9.28
78	Connecticut	ES	The CT Light & Power Co	9.25
79	Kentucky	DUK	Duke Energy Kentucky Inc.	9.25
80	Arizona	FTS	Tucson Electric Power Co.	9.15
81	Connecticut	IBE	The United Illuminating Co.	9.10
82	New Hampshire	AQN	Liberty Utilities Granite St	9.10
83	New Mexico		El Paso Electric Co.	9.00
84	New York	NG.	Niagara Mohawk Power Corp.	9.00
85	New York	ED	Orange & Rockland Utlts Inc.	9.00
86	New York	FTS	Central Hudson Gas & Electric	8.80
87	New York	ED	Consolidated Edison Co. of NY	8.80
88	New York	IBE	NY State Electric & Gas Corp.	8.80
89	New York	IBE	Rochester Gas & Electric Co	8.80
90	Vermont		Green Mountain Power Corp.	8.57
91	Illinois	AEE	Ameren Illinois	8.38
92	Illinois	EXC	Commonwealth Edison Co.	8.38
93	Maine	IBE	Central Maine Power Co.	8.25

Summary

	Delta to PNW ROE of 9.17%	Authorized ROE (%)
Min	0.91%	8.25%
25th Percentile	(0.19%)	9.35%
Median	(0.42%)	9.58%
Mean	(0.45%)	9.61%
75th Percentile	(0.74%)	9.90%
Max	(2.79%)	11.95%

Attachment C

2013 WL 326012
Only the Westlaw citation is currently available.
NOTICE: THIS DECISION DOES NOT CREATE LEGAL PRECEDENT AND MAY NOT BE CITED EXCEPT AS AUTHORIZED BY APPLICABLE RULES. See Ariz. R. Supreme Court 111(c); ARCAP 28(c); Ariz. R.Crim. P. 31.24
Court of Appeals of Arizona,
Division 1, Department D.

SAMARITAN HEALTH SYSTEM, an Arizona corporation dba Desert Samaritan Hospital, Good Samaritan Medical Center, Havasu Samaritan Regional Hospital, Maryvale Samaritan Hospital, Thunderbird Samaritan Hospital, and Page Hospital; Arrowhead Hospital, an Arizona corporation; Medical Environments, Inc., a California corporation dba Bullhead Community Hospital; Carondelet Health Services, Inc., an Arizona corporation dba Carondelet St. Joseph's Hospital and Carondelet St. Mary's Hospital; Casa Grande Regional Medical Center, an Arizona corporation; Chandler Regional Hospital, an Arizona corporation; Mesa General Hospital, an Arizona corporation dba Community Hospital Medical Center; Sun Health Corporation, an Arizona corporation dba Del E. Webb Memorial Hospital and Walter O. Boswell Memorial Hospital; Flagstaff Medical Center, Inc., an Arizona corporation; Healthwest Regional Medical Center, an Arizona corporation; Holy Cross Hospital And Health Center, Inc., an Arizona corporation; John C. Lincoln Hospital and Health Corporation, an Arizona corporation; Kingman Hospital, Inc., an Arizona corporation dba Kingman Regional Medical Center; Marcus J. Lawrence Medical Center, an Arizona corporation; Mesa General Hospital Medical Center, Inc., an Arizona corporation; Lutheran Health Network, an Arizona corporation dba Mesa Lutheran Hospital and Valley Lutheran Hospital; Paradise Valley Hospital, an Arizona corporation; Phoenix Baptist Hospital, an Arizona corporation; Phoenix Children's Hospital, an Arizona corporation; Phoenix Memorial Hospital, an Arizona corporation; Scottsdale Memorial Hospital, an Arizona corporation; Mercy Healthcare Arizona, an Arizona corporation dba St. Joseph's Hospital and Medical Center; Sierra Vista Community Hospital, an Arizona corporation; Tucson Medical Center, an Arizona corporation; University Medical Center Corporation, an Arizona corporation; Yavapai Regional Medical Center, an Arizona corporation; and Yuma Regional Medical Center, an Arizona Corporation, Plaintiffs/Appellees,
v.
ARIZONA HEALTH CARE COST CONTAINMENT SYSTEM ADMINISTRATION, an Agency of the State of Arizona; and Tom Betlach (successor to Anthony Rodgers), in his capacity as Director, Defendants/Appellants.

No. 1 CA–CV 12–0031.
|
Jan. 29, 2013.

Appeal from the Superior Court in Maricopa County; Cause No. LC 2009–000282–001; The Honorable Crane McClennen, Judge. REVERSED; REMANDED.

Attorneys and Law Firms

Gammage & Burnham, PLC By Cameron C. Artigue, Richard B. Burnham, George U. Winney, Phoenix, Attorneys for Plaintiffs/Appellees.

Johnston Law Offices PLC By Logan T. Johnston III, Phoenix, Attorneys for Defendants/Appellants.

MEMORANDUM DECISION

JOHNSEN, Judge.

***1** ¶ 1 The Arizona Health Care Cost Containment System Administration ("AHCCCS") appeals from the superior court's determination that AHCCCS abused its discretion when it modified certain rates it paid hospitals for services for AHCCCS patients during the late 1990s. We conclude AHCCCS did not abuse its discretion in adopting the rates and reverse the judgment in favor of Samaritan Health Systems and other hospitals (collectively, "Samaritan") and remand for entry of judgment in favor of AHCCCS.

FACTS AND PROCEDURAL HISTORY

¶ 2 AHCCCS administers Arizona's Medicaid program through a federal-state partnership pursuant to Title XIX of the Social Security Act. *See* 42 U.S.C. §§ 1396a *et seq.* (West 2013).[1] At issue here is one aspect of the methodology AHCCCS developed in 1993 to reimburse hospitals for treating Medicaid patients between 1994 and 1999. This is the second time this case has come before this court in litigation spanning 17 years.

¶ 3 The methodology at issue reimbursed hospitals through two mechanisms. The first mechanism, applicable to most patient cases, was a tiered per diem rate under which AHCCCS paid hospitals a fixed amount for each day a patient in a particular class was hospitalized. The classes, called tiers, distinguished patients based on their condition and care, such as a maternity, surgery or intensive care. *Samaritan Health Sys. v. Ariz. Health Care Cost Containment Sys. Admin.,* 198 Ariz. 533, 535, ¶ 3, 11 P.3d 1072, 1074 (App.2000). The per diem rates were determined prospectively based on the statewide average cost of treating the various tiers of patients.

¶ 4 The hospitals requested, and AHCCCS agreed, to provide an alternate reimbursement mechanism for a small class of patients whose treatment was extraordinarily more expensive than others. This mechanism applied to "exceptionally high cost" claims, termed "outliers." AHCCCS reimbursed hospitals for outlier claims by paying them a fixed percentage of the total costs hospitals incurred in treating these particular cases. *Id.* at ¶ 5. The percentage was "based on the statewide ratio of total hospital costs to total charges." *Id.*

¶ 5 Under a formula used by AHCCCS, a hospital claim was put into the "outlier" tier when

> the cost per day, excluding capital and medical education, is in excess of the greater of:
>
> a. The weighted average operating cost per day within a tier plus or minus three standard deviations, or
>
> b. The overall weighted average operating cost per day plus or minus two standard deviations across all tiers.

Ariz. Admin. Code ("A.A.C.") R9–22–101.84. As devised by AHCCCS, this formula was intended to put about one percent of all cases into the outlier tier. Because outliers were not paid at the per diem rates, AHCCCS did not include the outliers' costs in calculating the per diem rates; to do so would have disproportionately raised the per diem rate. *Samaritan,* 198 Ariz. at 535, ¶ 6, 11 P.3d at 1074. The per diem rates therefore were based on the statewide average cost to hospitals of treating all non-outlier claims in a particular tier. *Id.*

***2** ¶ 6 The present dispute stems from AHCCCS's annual revisions of the outlier threshold between 1994 and 1998. When the methodology was developed in 1993, there was no statutory provision that explicitly provided for an outlier component to the reimbursement scheme. The original enabling statute for the implementation of the system, Arizona Revised Statutes ("A.R.S.") section 36–2903.01(J) (1993), only provided for per diem payments and periodic revisions to the per diem payments. At the time, the enabling statute in pertinent part provided:

> 1. For inpatient hospital stays, the administration *shall* use a *prospective tiered per diem methodology* ... [including a] stop loss-stop gain or similar mechanism ... [that ensures] that the tiered per diem rates assigned to a hospital do not represent less than ninety per cent of its 1990 base year costs or more than one hundred ten per cent of its 1990 base year costs, adjusted by an audit factor, during the period of March 1, 1993 through September 30, 1994. The

tiered per diem rates set for hospitals shall represent no less than eighty-seven and one-half per cent or more than one hundred twelve and one-half per cent of its 1990 base year costs, adjusted by an audit factor, from October 1, 1994 through September 30, 1995 and no less than eighty-five per cent or more than one hundred fifteen per cent of its 1990 base year costs, adjusted by an audit factor, from October 1, 1995 through September 30, 1996.... An adjustment in the stop loss-stop gain percentage may be made to ensure that total payments do not increase as a result of this provision.

> 2. For rates effective on October 1, 1994, and *annually* thereafter, the administration *shall* adjust tiered per diem payments for inpatient hospital care by the data resources incorporated market basket index for prospective payment system hospitals and *shall* also adjust payments to reflect changes in length of stay.
>
> 3. Subsequent to October 1, 1993, the administration *shall* recalculate the per diem payments every *two to four years,* as determined by the administration, using an updated data base of hospital claims and encounters.

A.R.S. § 36–2903.01(J) (1993) (emphasis added).

¶ 7 Under the statute, AHCCCS was obligated to adjust the per diem rates annually to take into account inflation and changes in the length of hospitalizations, and every two to four years was required to more broadly recalculate the per diem payments it would make to hospitals based on costs actually incurred. When AHCCCS first annually updated the per diem rates pursuant to A.R.S. § 36–2903.01(J)(2) in 1994, however, it became clear that the number of claims beyond the outlier threshold had become significantly greater than one percent of total claims. To maintain the number of outliers at about one percent of total claims, AHCCCS increased its outlier threshold annually from 1994 to 1998 by recalculating the threshold "based on information it received from hospitals statewide and according to the' standard deviation' formula." AHCCCS codified this practice in 1997 by amending the Arizona Administrative Code to provide that:

> ***3** Update. Administration shall update the outlier cost thresholds and outlier charge thresholds for each hospital. The outlier cost thresholds are updated annually by recalculating the standard deviations based on the claims and encounters used for the length-of-stay adjustment....

A.A.C. R9–12–711(A)(5)(b).

¶ 8 When AHCCCS raised the outlier thresholds annually between 1994 and 1998, it did not also recalculate the per diem rates applicable to non-outlier claims. The result was that claims that fell just below the newly adjusted outlier threshold were paid at a per diem rate calculated based on other lower-cost claims. Samaritan contends that AHCCCS's manner of adjusting the outlier thresholds caused AHCCCS to underpay hospitals $96,000,000 over the four years in dispute. The disagreement over AHCCCS's increases in the outlier thresholds did not cease until the statute was modified in 1999 to freeze the thresholds in effect on October 1, 1999 and permit AHCCCS to adjust those thresholds annually only based on inflation. A.R.S. § 36–2903.01(J) (1999).

¶ 9 Samaritan successfully challenged the four annual outlier threshold modifications in superior court, but this court reversed, holding Samaritan had failed to exhaust its administrative remedies. *Samaritan,* 198 Ariz. at 534, ¶ 1, 11 P.3d at 1073. Samaritan then filed an administrative claim, arguing AHCCCS abused its discretion and acted arbitrarily and capriciously in raising the outlier thresholds. After a three-day evidentiary hearing, an administrative law judge ("ALJ") determined that AHCCCS "did not act outside of its legal authority and did not abuse its discretion by increasing the outlier thresholds in the manner that they were increased each year from 1994 through 1998." The ALJ premised his decision on his finding that the

> evidence shows that in considering how to exercise its discretion regarding outlier rates, [AHCCCS] considered the definition of outlier in the State Plan and its intention to keep outliers at one percent of all claims. Further, AHCCCS was aware that it could not recalculate the per diem rates each year, so that was not an option. Also, because of the specific wording of the statute, [AHCCCS] had authority to adjust for inflation only the "tiered per diem" rates and not any other rates. Finally, [AHCCCS] determined that length-of-stay adjustments for outlier rates would be covered by annually updating the outlier thresholds because the database used for the outlier updates contained length-of-stay data. Thus, the evidence shows a reasoned choice by AHCCCS that cannot be characterized as arbitrary or capricious.

¶ 10 After the Director of AHCCCS adopted the ALJ's decision in its entirety, Samaritan filed a complaint in superior court, and the court concluded AHCCCS abused its discretion in modifying the outlier thresholds because "[t]o the extent the legislature mandated that AHCCCS payment must relate to the hospitals' costs for treating those patients, the revised system would no longer satisfy the legislative mandate." The court reasoned that because AHCCCS did not have the statutory authority to recalculate the per diem rates annually pursuant to A.R.S. § 36–2903.01(J)(3) (1993), AHCCCS "should have left the threshold where it was so that the per diem accurately reflected the average cost for those cases below the threshold." We have jurisdiction over AHCCCS's timely appeal pursuant to A.R.S. §§ 12–120.21(A)(1) (West 2013) and–2101(A)(1) (West 2013).

DISCUSSION

A. Legal Principles.

***4** ¶ 11 Pursuant to A.R.S. § 12–910(E) (West 2013), in reviewing an agency's action, a "court shall affirm the agency action unless after reviewing the administrative record and supplementing evidence presented at the evidentiary hearing the court concludes that the action is not supported by substantial evidence, is contrary to law, is arbitrary and capricious or is an abuse of discretion." On appeal from a superior court's review of an administrative decision, "we consider whether the agency action was supported by the law and substantial evidence and whether it was arbitrary, capricious or an abuse of discretion." *Sharpe v. Ariz. Health Care Cost Containment Sys.,* 220 Ariz. 488, 492, ¶ 9, 207 P.3d 741, 745 (App.2009) (quotation omitted). We therefore focus on the AHCCCS Director's decision, which adopted the ALJ decision in its entirety, rather than the superior court's decision. *Id.* While we give great weight to an agency's interpretation of a statute or regulation it implements, "we review an agency's application and interpretation of the law *de novo,*" and therefore are "free to draw our own legal conclusions in determining if the [agency] properly interpreted the law." *Id.* at 492, 494, ¶¶ 9, 18, 207 P.3d at 745, 747 (quotation omitted).

¶ 12 An agency acts arbitrarily and capriciously when it does not examine "the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983) (quotation omitted). In the context of a federal agency regulation, a rule is arbitrary and capricious if "the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *Id.* Under this analysis, the question is whether the agency has taken an action "without consideration and in disregard for facts and circumstances; where there is room for two opinions, the action is not arbitrary or capricious if exercised honestly and upon due consideration, even though it may be believed that an erroneous conclusion has been reached." *Petras v. Ariz. State Liquor Bd.,* 129 Ariz. 449, 452, 631 P.2d 1107, 1110 (App.1981).

B. Given the Purpose of the Reimbursement Methodology and Governing Statutes, AHCCCS Did Not Abuse Its Discretion in Raising Outlier Thresholds.

¶ 13 Samaritan argues AHCCCS's modifications of the outlier thresholds during the four years in question were arbitrary and capricious because they "violate [d] the rules of arithmetic and undermine[d] the concept of a cost-based system." Samaritan argues that because the reimbursement system is based on costs, AHCCCS's decision to raise the outlier thresholds without recalculating the per diem rates "contradicts the essence of a cost-based system by forcing real costs to disappear from the system." It continues: "Under the *Motor Vehicle Manufacturers* ' standard, AHCCCS relied on 'irrelevant factors' and failed to think through 'important aspect[s] of the problem' by making its 'definition' of outliers the sole policy consideration. AHCCCS lost sight of other 'factors' that were 'relevant' to its decision—namely, the rules of arithmetic in the context of a cost-based system."

***5** ¶ 14 We cannot accept Samaritan's argument, however, because it rests on a fundamental mischaracterization of the purpose of the cost-based reimbursement system. While it is true that AHCCCS's decision to raise the outlier thresholds lowered the amount it paid hospitals under that payment mechanism, Samaritan points to nothing in the history or structure of the law requiring that hospitals must be reimbursed 100 percent of their costs for treating Medicaid patients. To the contrary, the history of the 1993 methodology and the language of the statute indicate that the per diem methodology was not intended to reimburse hospitals for all of the costs they incur in treating those patients. At the relevant time, § 36–2903.01(J)(1) (1993) provided that the initial rates "shall be based upon hospital claims and encounter data" for 1991–92. While requiring a payment mechanism "based upon" hospitals' costs, the statute did not specify that AHCCCS reimburse hospitals for all of their costs.

¶ 15 The 1993 cost-based methodology was a replacement for another payment method known as Adjusted Billed Charges ("ABC"), which reimbursed hospitals a percentage of their total *charges* (as distinct from their *costs*) for treating a Medicaid patient. The legislation that mandated the ABC system provided that its purpose was to keep reimbursement constant with 1984 levels. Thus, whenever a hospital would increase its charged rates, AHCCCS would adjust a hospital-specific "factor" downward by the amount of the increase so that the result would be payment at the 1984 level.

¶ 16 In reality, neither AHCCCS nor Samaritan was happy with how ABC worked. As a practical matter, the methodology did not hold reimbursements constant at 1984 levels because hospitals' billed charges were rising faster than AHCCCS could adjust the rates it applied to the hospitals' charges. And hospitals were concerned at what they saw as the prospect of a continually widening gap between charges and reimbursement.

¶ 17 Two 1988 studies recommended replacing the *charge-based* system with the 1993 cost-based system; the *cost*-based system was designed as a prospective payment system that would set fixed rates for services into the future, thus encouraging efficiencies. Nothing in the legislative history or the statute, however, suggested that the cost-based per diem methodology would result in AHCCCS reimbursing hospitals for 100 percent of their costs in treating a Medicaid patient. An expert for AHCCCS who was involved in developing the 1993 methodology, in fact, testified before the ALJ that the new system was never intended to reimburse hospitals their costs for every service they provided.

¶ 18 The text of A.R.S. § 36–2903.01(J)(1) further reflects the notion that hospitals were not to be reimbursed for all of their costs. The statute implemented a stop-loss/stop-gain provision for the three years following the implementation of the new system that delimited AHCCCS's payments to each hospital. For example, from 1993 to 1994, AHCCCS could not reimburse any hospital less than 90 percent or more than 110 percent of its 1990 costs. A.R.S. § 36–2903 .01(J)(1). Similarly, for the periods from 1994 to 1995 and 1995 to 1996, AHCCCS's payments were mandated to be between 87.5 percent and 112.5 percent and 85 percent and 115 percent of a hospital's 1990 costs, respectively. *Id.*

***6** ¶ 19 On appeal, Samaritan dismisses the stop-loss/stop-gain mechanism as a "temporary backstop for hospitals with above-average operating costs" because after 1996, hospitals were to be reimbursed according to the statewide per diem average. While this is literally true, Samaritan's argument ignores the statutory provision requiring AHCCCS to recalculate the statewide average "every two to four years, as determined by the administration." A .R.S. § 36–2903.01(J)(3). Thus, in enacting the statute, the legislature recognized that to the extent that costs rose, it would be two to four years before the per diem rates would be recalculated in response.

¶ 20 Further confirmation that the AHCCCS payment mechanism was not intended to guarantee that hospitals would be reimbursed for all of their costs is the explicit requirement in the Code of Federal Regulations that a state's Medicaid payments do not in the aggregate exceed what would have been paid under Medicare principles of reimbursement. The Medicare principle, in turn, requires reimbursement of only the lesser of reasonable costs or charges. 42 C.F.R. § 447.272 (West 2013).

¶ 21 Nevertheless, Samaritan contends that notwithstanding that the Arizona statute did not obligate AHCCCS to specially treat an outlier tier of the most expensive patient cases, once AHCCCS did implement the outlier component, it could not unilaterally raise the outlier threshold in a manner that resulted in shortfalls in per diem reimbursements. Samaritan argues the agency's decision to maintain the class of outliers as the most expensive one percent of cases was arbitrary and capricious.

¶ 22 This argument fails to recognize the purpose of the outlier component and the role it played in the wider statutory scheme. The outlier was one aspect of an otherwise complex, interconnected reimbursement system intended in part to contain hospital costs. The legislature's intent to contain costs can be seen within the statutory scheme. For example, A.R.S. § 36–2903(B)(4) (West 2013) notes that the administrator of the system has a responsibility to develop "a complete system of accounts and controls for the system including provisions designed to ensure that covered health and medical services provided through the system are not used unnecessarily or unreasonably.... The administrator shall periodically assess the cost effectiveness and health implications of alternate approaches to the provision of covered health and medical services through the system in order to reduce unnecessary or unreasonable utilization." Further, AHCCCS's expert testified the outlier component of the reimbursement mechanism was only one of several variables, some favoring AHCCCS and others favoring the hospitals, that made up the entire reimbursement scheme.

¶ 23 Given that a purpose of the program is to limit the costs of care, we cannot conclude AHCCCS acted arbitrarily by deciding it would reimburse only the most expensive one percent of cases at the outlier rate.

C. Samaritan's Contention that AHCCCS Should Have Adjusted the Outlier Threshold for Inflation Does Not Comport With the Methodology's Goal of Containing Costs.

***7** ¶ 24 Samaritan does not argue AHCCCS should have recalculated the per diem each year; it recognizes that A.R.S. § 36–2903.01(J)(3) did not authorize AHCCCS to recalculate the per diem rates annually. It contends, however, that rather than reset the outlier threshold annually to include only about the most expensive one percent of cases, AHCCCS should have adjusted the outlier cost threshold year to year based on inflation. So, for example, if costs rose five percent, Samaritan would have had AHCCCS raise the outlier threshold by five percent. This would mean the outlier threshold would have moved in tandem with the annual adjustment of per diem payments under A.R.S. § 36–2903.01(J)(2) to take into account inflation.

¶ 25 While AHCCCS rationally might have adjusted the outlier threshold as Samaritan suggests, we cannot conclude it acted arbitrarily by determining instead to maintain the outlier threshold at about the upper one percent of the patient cases. Following guidance from the United States Supreme Court, Arizona courts long have held that an agency does not act arbitrarily and capriciously merely because there is a difference of opinion as to what the agency should have done, as long as a "decision was reached after due consideration and upon a rational basis." *Griffith Energy, L .L.C. v. Ariz. Dep't of Revenue,* 210 Ariz. 132, 136, ¶ 19, 108 P.3d 282, 286 (App.2005).

¶ 26 *Griffith* illustrates the flaws in Samaritan's argument. A taxpayer in that case challenged the methodology by which the state Department of Revenue ("ADOR") valued depreciating personal property at electric generation plants. *Id.* at 133, ¶ 1, 108 P.3d at 283. A state statute allowed ADOR to adopt a valuation table for depreciation, and the agency chose a table that depreciated the value of the property over 25 years. *Id.* at ¶ 4. The taxpayer asserted ADOR should have adopted a 15–year depreciation table instead. *Id.* at ¶ 5. Rejecting the taxpayer's argument, this court pointed out that given the legislature's grant of authority to ADOR to adopt such a table, the taxpayer's disagreement with the table ADOR adopted did not demonstrate an abuse of discretion. *Id.* at 136–37, ¶¶ 19, 24, 108 P.3d at 286–87. We noted, "If ADOR exercised its discretion honestly and upon due consideration, and its decision was supported by substantial evidence, the tax court was required to uphold ADOR's adoption of the Table even if the court disagreed with ADOR's decision." *Id.* at 135, ¶ 16, 108 P.3d at 285. The court recounted that

> ADOR presented evidence that it selected a twenty-five-year depreciation life after gathering information from a variety of sources. Among other things, ADOR obtained information from new merchant and incumbent providers of electric generation services in Arizona, including Taxpayer, reviewed a depreciation study prepared on behalf of Pinnacle West Energy Corporation, and surveyed all other states to determine that they assigned life spans to electric generation plants ranging between twenty and thirty years. ADOR also hired independent experts to research and report on the life of a combined cycle plant.... Based on all this evidence, ADOR adopted a twenty-five-year life span for electric generation personal property....

***8** *Id.* at 136, ¶ 20, 108 P.3d at 286. Similarly, here, AHCCCS raised its outlier thresholds between 1994 and 1998 after considering a number of factors, including the state Medicaid plan's definition of outliers, A.R.S. § 36–2903.01(J), and the goal of containing costs. Accordingly, the agency's actions cannot be characterized as unsupported by substantial evidence or without due consideration.

¶ 27 Impliedly acknowledging the validity of AHCCCS's decision to adjust the outlier thresholds in some fashion, Samaritan argues that AHCCCS simply should have raised the threshold to account for inflation, rather than recalculating the threshold to maintain the number of outlier cases at about one percent. Samaritan argues AHCCCS acted arbitrarily and capriciously because its decision to maintain the threshold at one percent shortchanged Samaritan by $96 million.

¶ 28 But as AHCCCS points out, that calculation by Samaritan is based on unsupported assumptions about the reimbursement system. Samaritan calculated its "loss" by assuming every case it contends should be treated as an outlier actually would be reimbursed as an outlier. As AHCCCS's expert made clear, however, regardless of where the threshold is set, not every claim identified as an outlier is reimbursed as such. In fact, identifying a claim as an outlier is only one step in the overall scheme of how a hospital is reimbursed for such a claim. AHCCCS's expert testified that Samaritan's calculation did "not take into consideration other payments by third parties and quick pay, slow pay, and some of the other adjustments that are made to final reimbursement." As a result, Samaritan's assertion about the harm it suffered because of AHCCCS's decision to maintain the outlier threshold at about one percent of patient cases is overstated.

¶ 29 Second, Samaritan's current assertions are not premised on any of the flaws it identified in the proceedings before the ALJ. In those proceedings, Samaritan's expert submitted two reports, one in 1995 and another in 2002, each of which criticized the AHCCCS methodology for failing to recalculate the per diem rates to take into account costly patient cases that fell below the newly adjusted outlier thresholds. As noted, however, Samaritan now recognizes that AHCCCS by law could not have recalculated per diem rates annually. Accordingly, Samaritan's analysis of loss of $96 million was untied to its criticisms of the reimbursement system.

D. Samaritan's Reliance on *Judulang v. Holder* Is Inapposite.

¶ 30 Samaritan relies on *Judulang v. Holder,* 132 S.Ct. 476 (2011), as support for its contention that AHCCCS acted arbitrarily and capriciously in raising the outlier thresholds. In that case, the Supreme Court struck down as arbitrary and capricious the practice of the Board of Immigration Appeals ("BIA") of granting discretionary relief to aliens in deportation proceedings less frequently than in exclusion proceedings under an approach known as the "comparable-grounds" rule. *Id.* at 479. The Supreme Court determined that while the BIA may have had a legitimate reason for providing discretionary relief less frequently in deportation proceedings than in exclusion proceedings, its adoption of the "comparable-grounds" approach was an abuse of discretion because it did not award discretionary relief in a "rational way." *Id.* at 485. Samaritan analogizes *Judulang* to the present case, arguing that AHCCCS's alteration of the outlier thresholds was not rational, meaning it was arbitrary and capricious.

***9** ¶ 31 Samaritan misunderstands the import of *Judulang* to the present case. The Court premised its *Judulang* decision on the purpose of the federal immigration laws. The Court explained that the "comparable-grounds" approach had "no connection to the goals of the deportation process or the rational operation of the immigration laws." *Id.* at 487. The approach did "not rest on any factors relevant to whether an alien (or any group of aliens) should be deported." *Id.*

¶ 32 Contrary to the premise of Samaritan's argument, it is not the central purpose of the AHCCCS reimbursement scheme to ensure that hospitals are reimbursed for all of their costs. The decision by AHCCCS that Samaritan challenges was consistent with the goals of the reimbursement system.

E. Samaritan May Not Now Raise Its Due–Process Argument.

¶ 33 Samaritan argues its due-process rights were violated by the AHCCCS grievance process, in which it contends the AHCCCS Director is both the "defendant" and the "judge." *See* A.R.S. § 41–1092.08(B), (F) (West 2013) (grievance system); *Pavlik v. Chinle Unified Sch. Dist. No. 24,* 195 Ariz. 148, 152, ¶ 12, 985 P.2d 633, 637 (App.1999) (due-process). Such an argument, however, must be raised first in the administrative proceeding. *See Phoenix Children's Hospital v. Ariz. Health Care Cost Containment Sys. Admin.,* 195 Ariz. 277, 282, ¶ 18, 987 P.2d 763, 768 (App.1999) ("Allowing parties to build a factual record is one of the policies underlying the requirement that parties first seek a remedy from the agency before seeking judicial review."). Because Samaritan failed to raise this contention in the administrative proceeding, we will not address it.

CONCLUSION

¶ 34 For the reasons set forth above, we reverse the judgment in favor of Samaritan and remand for entry of judgment in favor of AHCCCS. Contingent on compliance with Arizona Rule of Civil Appellate Procedure 21, AHCCCS may recover its costs of appeal.

CONCURRING: ANDREW W. GOULD, Acting Presiding Judge and DONN KESSLER, Judge.

All Citations

Not Reported in P.3d, 2013 WL 326012

Footnotes

1 Absent material relevant revisions after the relevant date, we cite a statute's current version.

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